Currency Boost for UK Pension Funds

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Typical UK pension fund return in 2008

BNY Mellon Asset Servicing's latest quarterly CAPS survey reported that the typical UK pooled pension fund was down 20.3% during 2008. This was due to the traditionally large equity allocation of over 80%. The UK stock market fell 29.9%, while overseas equities lost 18.6%. Bond allocations performed well, with UK gilts rising 13.6% and overseas bonds up a staggering 56.4%. Any cash would have earned around 5.2% as markets fell.

It is less widely recognised how much worse the situation would have been if these pension funds had not benefited from huge foreign currency gains. If sterling's weakness had not inflated the value of overseas investments, the typical fund would have been facing losses of approaching 30%.

Windfall foreign currency gains boosted the typical fund by 10% in 2008.

Decomposition of returns

A pension fund's currency exposures derive principally from overseas equities and bonds. We can see from Table 1. that the typical foreign currency exposure was 40.9%, coming mainly from overseas equities. By any measure, this was a significant portfolio risk. The table uses standard index returns to represent the unhedged performance of each asset class, giving an estimated portfolio return of -18.0%, which is fairly close to the CAPS median return of -20.3% after costs and fees.

It is easy to ignore the currency contribution to return, because it is subsumed within the unhedged returns. However, it is straightforward to calculate the impact of currency, by comparing the unhedged asset return with the fully hedged asset return, as shown in Table 2. Obviously this makes no difference for domestic investments, but the currency impact was enormous on overseas equities and bonds. If the portfolio had been fully hedged, the return would have been -27.6%. Therefore there was a currency gain of 9.7% at the total portfolio level.

It is important to recognise that overseas investment involves two separable decisions. Firstly, you need to convert sterling into foreign currency. This is the currency decision. Secondly, you use the foreign currency to buy the overseas asset. This is the asset decision. The currency decision can be reversed by fully hedging the FX exposure. An unhedged exposure implicitly includes the currency decision, leaving the investor fully exposed to currency risk.

In 2008, the currency decision (to be unhedged) was highly profitable, whereas the foreign equity decision was distinctly negative. Fully hedged foreign equities fell 41.4%, significantly underperforming both UK equities and cash. Fully hedged foreign bonds underperformed UK bonds, but they did justify their place in the portfolio by outperforming cash.

Swings and roundabouts

Many pension funds do not take account of the currency decisions implicit in their portfolios. The 2008 example shows that with 41% of the portfolio exposed to currency, the impact at the total portfolio level was close to 10%. Spare a thought for US and Japanese investors who saw negative asset returns compounded by foreign currency translation losses of a similar order of magnitude. Some are facing losses of 40% in 2008.

Having experienced such a fantastic currency gain, it is natural to ask some forward-looking questions. Should funds remain unhedged in anticipation of further foreign currency gains? Or does it make sense to lock in the recent windfall by raising hedges?

Foreign currencies make up ground

The weakness of the pound reverses an extended period of sterling strength. Over the 19 years covered by Chart 1, all three of the major foreign currencies have weakened against sterling, in spite of the pound's fall in the 1992 ERM debacle and its dramatic plunge of 2008. This means that an unhedged UK investor would still be behind a fully hedged investor over that period. The explanation is that the UK has had persistently higher interest rates for most of the period, which have cumulatively offset the exchange rate moves. This effect is not shown in more familiar charts of spot

Table 1: Typical Pooled Pension Fund Allocation and Index Returns

	Allocation Dec-08	Unhedged Returns
UK Equities	43.5	-29.9%
Overseas Equities	39.3	-18.6%
UK Bonds	7.6	13.6%
Overseas Bonds	1.6	56.4%
Cash	6.8	5.2%
Other[1]	1.2	5.2%
Total	100.0	-18.0%

Source: Allocation: BNY Mellon Asset Servicing, CAPS survey; Returns: DataStream

Table 2: Decomposition of Typical Pooled Pension Fund Returns

	Allocation Dec-08	Unhedged Returns	Hedged Returns	Currency Impact
UK Equities	43.5	-29.9%	-29.9%	0.0%
Overseas Equities	39.3	-18.6%	-41.4%	22.8%
UK Bonds	7.6	13.6%	13.6%	0.0%
Overseas Bonds	1.6	56.4%	11.4%	45.0%
Cash	6.8	5.2%	5.2%	0.0%
Other	1.2	5.2%	5.2%	0.0%
Total	100.0	-18.0%	-27.6%	9.7%

Source: Allocation: BNY Mellon Asset Servicing, CAPS survey; Returns: DataStream

[1] Property, index linked gilts and other investments, assumed to match the return on cash

exchange rates, which fail to reflect the interest rate differential.

From the longer term perspective, foreign exchange exposure has added risk and reduced return. This inauspicious combination seriously undermines the case for an unhedged benchmark. However, noting that the currency gains of 2008 coincided with falls in the equity market, one must assess whether this negative correlation is stable or transient. Unfortunately there is no firm logical case and the empirical evidence is lacking.

With an apparently strong case against the unhedged position, why not fully hedge foreign currency exposure? Well, that would have seemed fine until it became necessary to pay out 9.7% of the portfolio's assets in negative cash flows as sterling fell in 2008, with most of this concentrated in the last quarter. This would have come on top of the concurrent falls in asset prices and other demands for cash. Passively hedged UK investors have been forced to liquidate assets at a highly undesirable time.

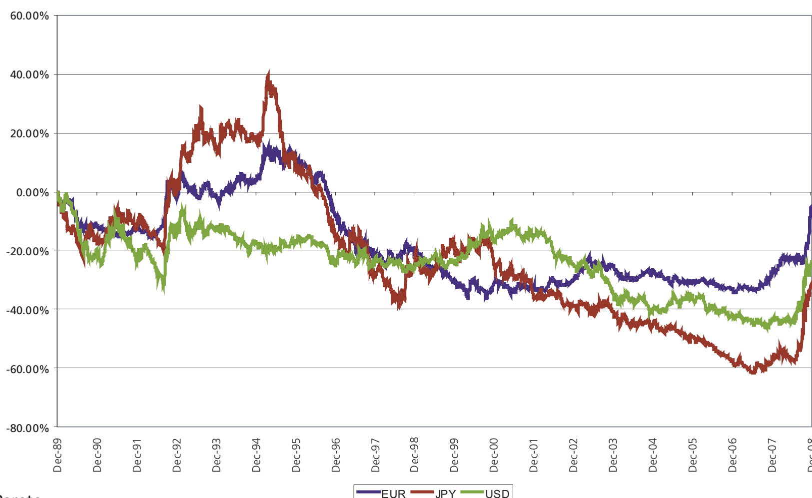
We must conclude that choosing a static hedging policy is not easy. The example highlights the fact that a currency hedging policy needs to be active, not passive. As John Maynard Keynes asked, "When the facts change, I change my mind. What do you do, sir?"

After sterling's 2008 plunge

The pound fell so much in 2008 that interest rate differentials had little impact. Foreign currency gains were 30.3% on the euro, 35.9% on the US dollar and 63.5% on the yen, averaging at around 38% on the mix of currencies in a typical foreign equity or bond portfolio.

Most of sterling's recent weakness was in the second half of the year, concentrated in the last quarter. Although there is some similarity with the events of 1992, the circumstances were entirely different, so it is hard to draw any direct analogies. However, close observation of Chart 1 shows that the pound has a tendency to strengthen slowly and to fall rapidly: to go up the stairs and down the lift shaft. This means that a fully hedged investor must act quickly to capture brief opportunities and avoid large negative cash flows. Over the longer term, unhedged investors have incurred a slow bleed of currency losses, punctuated by sudden sharp gains.

Chart 1: Foreign currencies versus sterling, including interest rate differentials



Source: Pareto

As ever, it is extremely hard to prognosticate on sterling's path. Strategists often hedge their bets by forecasting opposite tendencies over different time horizons: in the short run, the pound is oversold, yet on the long term it has room to fall further. This way they can always say they were right.

Since Keynes is currently in fashion, we advise pension funds to consider his question. The answer depends on identifying the crucial facts that should lead to a change of stance. The view embedded in Pareto's Currency Risk Management strategy is that the relevant facts lie in measures of the probability of loss. An active approach to currency hedging, based on managing negative outcomes, offers an attractive way to navigate these uncertain waters.

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