AVON PENSION FUND

Currency Hedging Considerations

The Fund's policy is to passively hedge overseas currency exposure where appropriate, to reduce the volatility of returns. Specifically, the Fund hedges 50% of the currency exposure on its overseas equities, and 100% for the global property, infrastructure and fund of hedge funds mandates.

The rationale for the higher hedge ratio on the latter mandates reflects the lower expected volatility of the underlying return drivers which the Fund wishes to benefit from over the long-term, meaning that the relatively higher variability in currency movements could easily outweigh the returns of the underlying asset classes. For example, in the case of hedge funds, the underlying return drivers that the Fund is aiming to tap into are the skills of a diversified range of unconstrained active managers that, in theory, have the potential to exploit a range of return opportunities (long only and relative value) on a dynamic basis with a relatively low correlation to equity markets. However, the base currency of the underlying hedge funds is in US$. If the US$ to Sterling currency risk was unhedged, the Fund would be exposed to the underlying hedge fund returns, plus movements in the US$ versus GBP exchange rate, with the latter being more volatile than the former. Hence, this could undermine the reason for investing in hedge funds in the first place. Similar arguments apply to global property and infrastructure.

Since the result of the European Union Referendum, Sterling has fallen significantly against other major currencies (down from $1.48 on 23 June 2016 to $1.33 on 31 July 2016), resulting in negative returns in Sterling terms for the four currency hedged mandates (see the appendix, which demonstrates negative currency returns for all major currencies over the quarter).

We expect currency volatility to continue, and as such believe that the Fund should keep the currency hedge in place to protect against this volatility. While further falls in Sterling are clearly possible, if the Fund was to remove the currency hedge it would be exposed to potentially material losses if Sterling was to rebound over a given period.

Further, we still believe that a passive currency hedging strategy remains appropriate, due to the lower fees and greater certainty of the levels of risk reduction than the dynamic approach previously used, particularly if markets "whipsaw".

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Partner
August 2016

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Appendix

Currency Hedge Returns over Q2 2016

Passive Developed Equity Currency Hedge

Currency	Start Exposure (£)	End Exposure (£)	Currency Return (%)	50% Hedge Return (%)	Record Hedge Return (%)
USD	572,761,642	548,740,916	7.52%	(3.87%)	(3.83%)
EUR	188,644,012	160,475,476	4.82%	(2.50%)	(2.50%)
JPY	130,089,526	125,406,018	17.79%	(8.87%)	(8.84%)
Total	**891,495,180**	**834,622,411**	**8.45%**	**(4.31%)**	**(4.28%)**

Passive Property Currency Hedge

Currency	Start Exposure (£)	End Exposure (£)	Currency Return (%)	100% Hedge Return (%)	Record Hedge Return (%)
USD	36,421,737	33,418,344	7.52%	(7.75%)	(7.64%)
EUR	134,164,968	136,191,661	4.82%	(4.89%)	(4.96%)
Total	**170,586,705**	**169,610,005**	**12.18%**	**(5.46%)**	**(5.49%)**

Passive Hedge Fund Currency Hedge

Currency	Start Exposure (£)	End Exposure (£)	Currency Return (%)	100% Hedge Return (%)	Record Hedge Return (%)
USD	194,312,572	187,295,246	7.52%	(7.66%)	(7.64%)
Total	**194,312,572**	**187,295,246**	**7.52%**	**(7.66%)**	**(7.64%)**

Passive Infrastructure Currency Hedge (17 May 2016 – 30 June 2016)

Currency	Start Exposure (£)	End Exposure (£)	Currency Return (%)	100% Hedge Return (%)	Record Hedge Return (%)
USD	69,295,032	78,259,428	8.07%	(8.10%)	(8.07%)
EUR	15,114,049	14,698,035	5.87%	(5.88%)	(6.00%)
Total	**84,409,081**	**92,957,464**	**7.72%**	**(7.74%)**	**(7.73%)**

Source: Record.