Bath & North East Somerset Council		
MEETING:	**AVON PENSION FUND COMMITTEE**	
MEETING DATE:	**24 JUNE 2011**	**AGENDA ITEM NUMBER**
TITLE:	**CURRENCY HEDGING - MANAGER APPOINTMENT**	
WARD:	ALL	
AN OPEN PUBLIC ITEM		
List of attachments to this report: Exempt Appendix 1 – Summary of Appointment		

1 THE ISSUE

1.1 On 25 June 2010 the Avon Pension Fund Committee resolved to appoint a specialist manager to implement an active currency hedging mandate covering US Dollar, Euro and Yen denominated equity assets (excluding those in emerging markets).

1.2 It was specified that the manager to be appointed adopts a non-discretionary quantitative approach to active currency hedging.

1.3 The appointment was delegated to Officers in consultation with the Chair of the Committee and Members of the Investment Panel. After consultation with the Chair of the Committee and Chair of the Investment Panel, Officers, the Fund's Investment Consultant and the Fund's Independent Advisor met on the 24 May 2011 to make the selection.

1.4 This report updates Members on the completion of the selection process and the decision to appoint Record Currency Management.

2 RECOMMENDATION

2.1 **That the Committee notes the appointment of Record Currency Management as active currency hedging manager.**

3 FINANCIAL IMPLICATIONS

3.1 The process generates positive and negative cash flows. Negative cash flows will be managed by Officers in conjunction with the manager, and met through the Fund's cash holdings.

3.2 The Fund's budget incorporated a provision for the associated management and consultancy fees.

4 BACKGROUND

4.1 As all investment values and returns are expressed in sterling (the Fund's base currency), foreign exchange movements generate additional volatility of returns. Following its review of the strategic investment policy in 2009/10 the Committee agreed to hedge the Fund's overseas equity assets to reduce the volatility of investment returns expressed in sterling terms.

4.2 Note that the Committee previously ***concluded that active currency management was not appropriate for the Fund***, given the lack of evidence for its success and that it increases investment risk. Active currency management describes the approach where managers take positions in currency markets based on their views on the direction of exchange rates globally, with the aim of making profits from currency market movements.

4.3 The Committee also ***rejected the option to passively hedge*** the assets. Passive hedging removes all the gains and losses that arise from movements in the exchange rates of the assets hedged. The Committee ruled out passive hedging because the net impact of currency movements over the long term are broadly neutral, yet in the short term can generate large cash flow movements when there are significant changes in foreign currency rates.

4.4 The Committee ***agreed that active currency hedging*** should be undertaken by the Fund. Active hedging aims to protect the sterling value of the portfolio from detrimental movements in exchange rates (i.e. when sterling is appreciating) whilst allowing the Fund to benefit from favourable movements (i.e. when sterling is weakening). In addition, the potential cash flows are minimised using this approach.

4.5 Under active hedging the proportion to be hedged will depend on the trend in the each underlying currency; therefore the hedge will be between 0% and 100% of the assets at any time. For example, when sterling is weak, the hedge ratio will be zero. It may be the case that sterling is weak against the dollar so there is no hedge and yet is strengthening against the euro so a hedge will be put on to protect the sterling returns from the euro denominated assets.

4.6 The Committee resolved that the Fund's US Dollar, Japanese Yen and Euro denominated equity assets (excluding emerging markets) should be hedged (at the time of going out to tender this was estimated to comprise c. £500m of the Fund's £850m overseas equity assets) and that the manager appointed should adopt a quantitative based, non-discretionary approach to hedging. **This means that the hedging process does not rely on the manager's view on currencies or "skill" in predicting currency trends.**

4.7 A non-discretionary manager will use a mechanistic/quantitative model based on the current and future foreign exchange rates in the market. The downside of this approach is that in periods of low volatility in foreign exchange rates higher transaction costs will be incurred.

5 THE SELECTION PROCESS

5.1 On 25 June 2010 the Committee resolved to delegate the appointment of the global equity manager to Officers in consultation in consultation with the Chair of the Committee and Members of the Investment Panel.

5.2 Due to the size of the mandate (hedging a portfolio of c. £500m) the fees exceed the Official Journal of the European Union (OJEU) limit and therefore a full OJEU procurement exercise was followed. A restricted procurement process was followed using the Council's online procurement portal. The online system generates an audit log of the whole process.

5.3 The Fund commissioned its investment consultant, JLT, to manage the tender process. The restricted tender was conducted and all investment managers that expressed an interest were required to complete a Pre Qualification Questionnaire (PQQ). After evaluating the PQQ submissions, 7 suppliers were invited to submit a bid.

5.4 The **selection process** was as follows:

(1) Officers agreed tender specification and evaluation criteria with JLT (see below)

(2) JLT and Officers developed the PQQ and tender questionnaire based on the evaluation criteria. It was designed to help identify investment managers with a greater likelihood of being able to consistently deliver the requirements of the mandate over the medium term.

(3) The Fund received 15 responses to the PQQ and invited 7 suppliers to tender. The tenders were evaluated based on the pre-determined criteria. These were then discussed with the officers and the Fund's independent advisor.

(4) Having completed further due diligence involving site visits to managers' offices, the Officers along with the Independent Advisor and Investment Consultant shortlisted 2 managers. The 2 managers were invited to a selection panel meeting at which the panel (made up of officers, investment consultant and independent advisor) clarified the information provided in the submissions and selected the manager to appoint.

5.5 The **specification** as set out in the tender documentation was as follows:

- Management of an active currency hedging programme covering the Fund's US dollar, euro and yen denominated overseas equity assets
- Objective is to reduce the volatility of investment returns in sterling and minimise cash outflows associated with currency hedging whilst capturing the gains from favourable exchange rate movements

5.6 The **evaluation criteria** used to assess submissions is set out below. The percentages show the weighting given to each element.

Evaluation Criteria	Weighting
Corporate Structure and Resources	20%
Investment Philosophy and Process	30%
Risk Management and Portfolio Construction (including investment and operational risk management)	25%
Performance including Risk	5%
Fees	10%
Client Service	10%

6 DECISION TO APPOINT

6.1 After assessing the submissions, the Selection Panel agreed to appoint Record Currency Management. Reasons for this include:

- Clear philosophy and approach
- Approach well aligned with Fund's objective
- Strong evidence of ability to implement and service the mandate to meet the Fund's requirements

Further details on Record, their management approach and process are in the exempt appendix 1.

6.2 This appointment is subject to completion of a legal agreement between the Fund and Record.

6.3 The portfolio will be managed on a segregated basis meaning that the Fund's custodian (BNY Mellon) will be responsible for the safekeeping of assets and settlement of all transactions.

7 RISK MANAGEMENT

7.1 The Avon Pension Fund Committee is the formal decision-making body for the Fund. As such it has responsibility to ensure adequate risk management processes are in place. It discharges this responsibility by ensuring the Fund has an appropriate investment strategy and investment management structure in place that is regularly monitored. In addition it monitors the benefits administration, the risk register and compliance with relevant investment, finance and administration regulations. The creation of an Investment Panel further strengthens the governance of investment matters and contributes to reduced risk in these areas.

8 EQUALITIES

8.1 An equalities impact assessment is not necessary.

9 CONSULTATION

9.1 This is reporting the outcome of a consultation process.

10 ISSUES TO CONSIDER IN REACHING THE DECISION

10.1 Are contained in the report.

11 ADVICE SOUGHT

11.1 The Council's Monitoring Officer and Section 151 Officer (Divisional Director - Finance) have had the opportunity to input to this report and have cleared it for publication.

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Background papers	
Please contact the report author if you need to access this report in an alternative format	