DORSET COUNTY PENSION FUND CURRENCY HEDGING AHEAD OF EU REFERENDUM

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1 EXECUTIVE SUMMARY

This report has been prepared for the Committee of the Dorset County Pension Fund ("the Fund"), and addresses the impending in-out referendum on European Union ("EU") membership (commonly referred to by the term "Brexit") and its likely economic impact. Our perspective is that of the Fund: as a Sterling ("GBP") investor having assets invested in Global (Overseas) Equities. Specifically we address if it is prudent to alter the Fund's currency hedging levels from the default 50% position for GBP against the Euro ("Euro"), US Dollar (USD) and Japanese Yen ("JPY").

The report primarily covers the following points:

- Latest political position on EU Referendum
- Potential impact of EU exit
- Currency hedging strategy implications

We conclude that for a Sterling investor holding Overseas assets (e.g. Global Equities), the subsequent depreciation of GBP following a vote to leave the EU would be positive. From this perspective, risks for such investors are centred on a possible outcome of a stay vote "winning" the referendum.

Clearly, however, this is a view based on a currency hedging perspective only, and there are other very material/significant economic and financial risks that could arise from any UK exit from the EU, particularly in the short term. These risks could, in aggregate, outweigh any currency hedging implications.

The convergence of recent opinion polls regarding the stay or leave position suggests that the result may well be too close to call. Therefore we believe that the Fund's current 50% hedging position against the major overseas currencies should remain "as is".

2 LATEST POLITICAL POSITION ON EU REFERENDUM

JLT is not specifying preference in this paper for either the “Stay” or “Leave” campaigns but below we outline the latest political situation as of early on 22nd February 2016:

UK Prime Minister David Cameron promised to hold an in-out referendum on EU membership by the end of 2017, largely motivated by political rather than economic factors, having been a Conservative Party manifesto pledge during the 2015 UK General Election.

After month of behind the scenes negotiations to achieve a “better deal for Britain” within the EU, final talks between the Prime Minister and the EU were held in Brussels last week. After a marathon negotiation session, the Prime Minister has outlined the terms of reform negotiated and thus has promptly announced a date for the “In/Out” referendum of 23rd June 2016.

Most analysts and market participants were anticipating the referendum to be held in September – October 2016 and things have moved very swiftly possibly because of what the Prime Minister believes to be better than expected results of negotiations.

However, what was specified by the Prime Minister as a strong deal with the EU for the UK was supposed (according to many commentators) to sway the vote in favour of stay but judging by the reactions of Conservative MPs and financial markets, it is unlikely that the stay campaign has any upper hand as of now.

Of course, the outcome of negotiations has not changed the position of Eurosceptics who were never too enthusiastic about the negotiations in the first place. The Prime Minister is facing a stiff opposition from his own Conservative MPs and some members of opposition alike. Post the announcement of the referendum date, London Mayor Boris Johnson has thrown his weight behind the leave vote. This is a significant development as Mr Johnson is one of the few British politicians with a positive approval rating and is supposedly viewed by the Prime Minister as a threat to his leadership position in the Conservative Party. The Prime Minister was not impressed by Johnson’s stance on the issue and quipped that the Mayor of London appeared to be putting his political ambition to lead the Conservative party ahead of the interests of London as a global financial centre.

The leave campaign has gathered initial momentum with a series of rallies and cross party political groups forming alliances in recent days.

However, Britain’s biggest companies are strongly supporting staying in the EU and the leaders of many of Britain’s biggest companies are expected to imminently sign a letter to argue that Britain is “stronger, safer and better off” in a reformed EU.

The political rhetoric and battles regarding the EU referendum are truly only just beginning.

3 POTENTIAL IMPACT OF EU EXIT

Any decision to leave would be significant and potentially negative for the UK economy (at least in the short term). If there were a vote to leave the EU, the UK would likely have two years to negotiate its post-exit relationship with the EU. This period of uncertainty would very likely make the financial markets more volatile.

The long term impact on UK GDP is difficult to compute and the estimates are wide ranging, from -20% to +5%. However, in the short term, exit would be costly to the UK economy and GBP. Some analysts have predicted as much as a 20% drop in GBP value could occur in a very short period of time.

The UK government and Bank of England would most likely be forced to take defensive measures for example implementing fiscal stimulus and cutting the base interest rate and, thereafter, keeping it low for extended period of time.

While there are a multitude of potential implications should an exit of the EU be undertaken, some key issues are highlighted below:

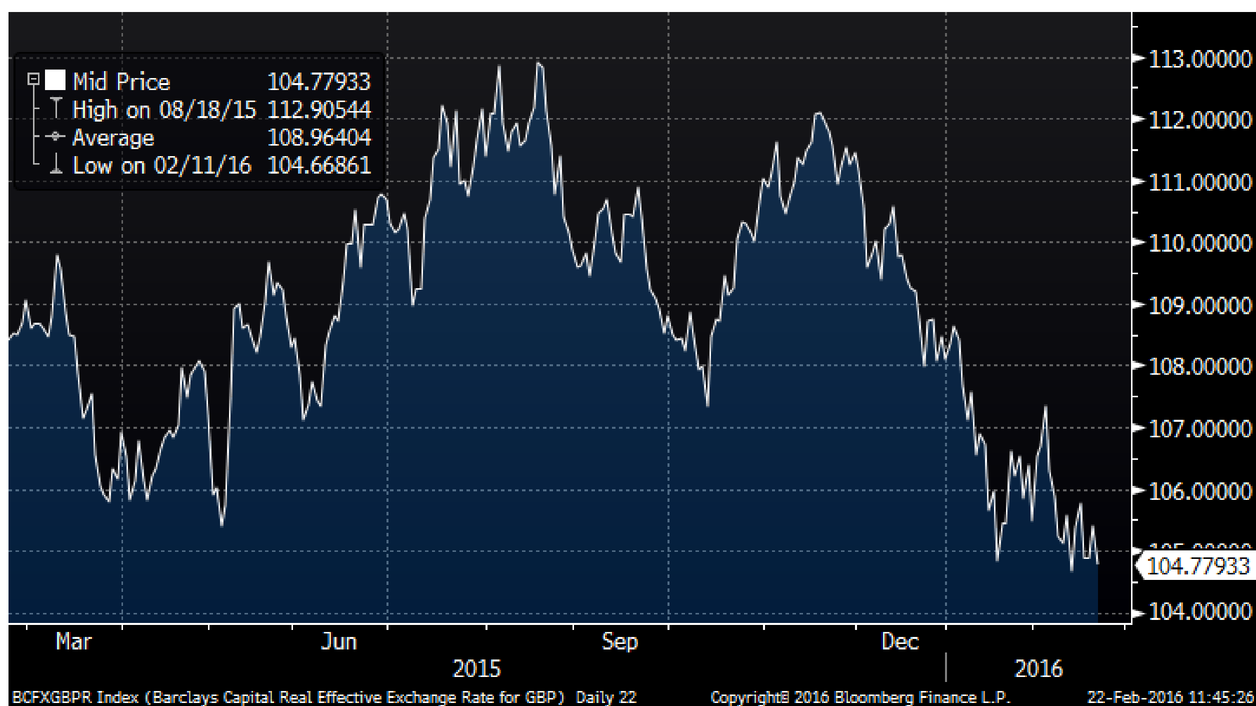
- Long term impact of the exit is difficult to predict
- In short term however, GBP is likely to sharply depreciate and yields on Gilts could rise significantly
- UK policymakers may be required to act swiftly to control disorderly markets
- In the two years following the exit vote, the UK policymakers will have to negotiate exit agreements with the EU and also establish free trade agreements with rest of the world (as the EU negotiated pacts would no longer apply)
- Uncertainty may persist for a long time after the vote as new trade agreements take place and markets fathom the cost/benefits of them
- Some sizable businesses may leave the UK

4 CURRENCY HEDGING STRATEGY IMPLICATIONS

While most are focussed on the risk of the leave vote winning the referendum, for Sterling investors holding assets (for example Equities) in Overseas currencies (such as the Fund) the risks are exactly the opposite.

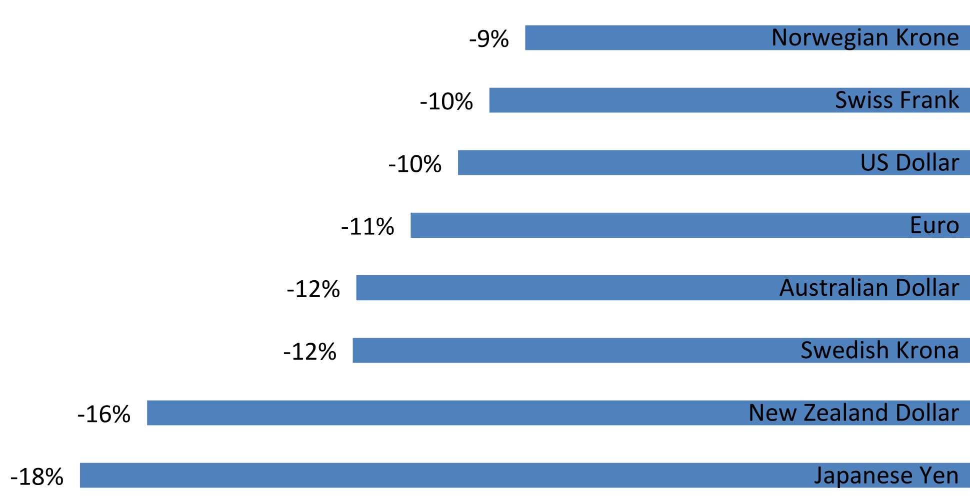
As explained in Section 3, a leave vote would very likely result in significant depreciation of the GBP relative to the US Dollar and Japanese Yen. On balance, the EUR-GBP rate may not be affected that much (relative to the other major global currencies). Any devaluation in Sterling would add to the returns generated abroad and would therefore be positive for Sterling investors.

The GBP has been depreciating against major currencies for the past few months, as the following chart showing the Real Effective Exchange Rate of GBP demonstrates:



Source: Bloomberg

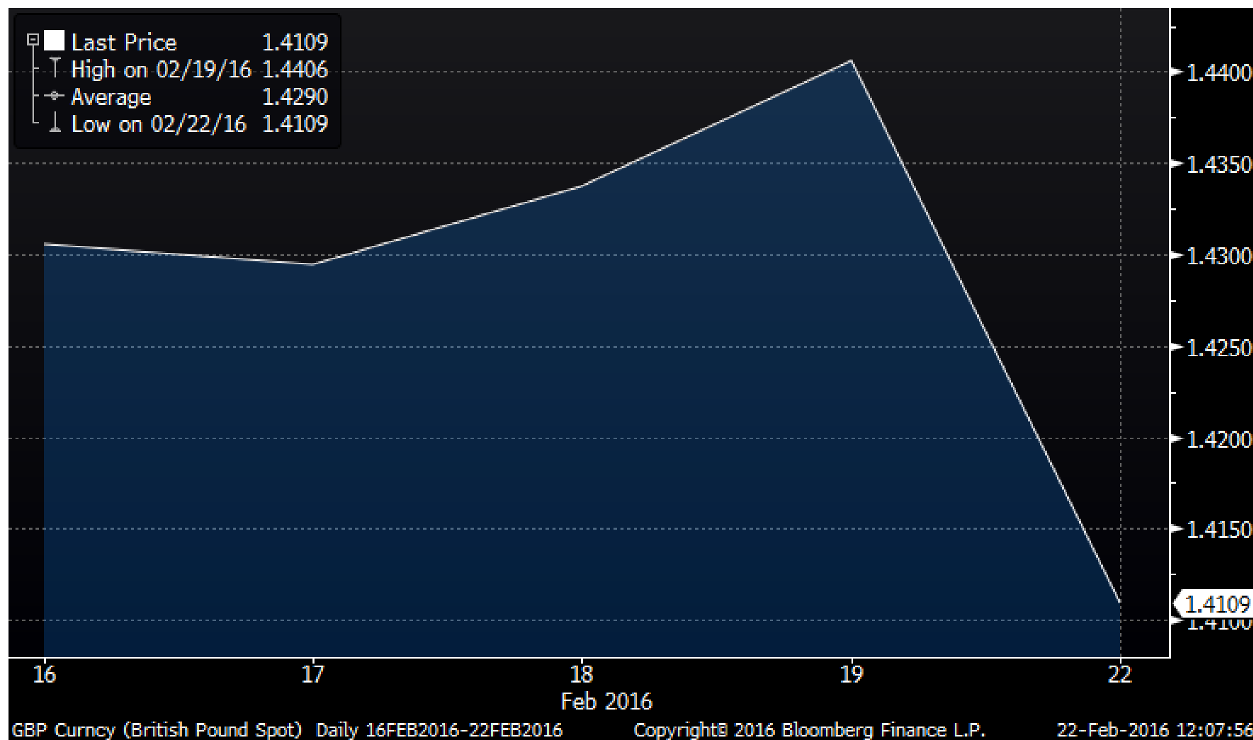
The depreciation in GBP has been broad based against all major currencies. The following chart shows the GBP currency returns against the global currency majors since the most recent peak in 2015.



Source: Financial Times

A significant portion of the underperformance of GBP can be attributed to the Brexit fears. Indeed, the market reaction following the announcement of the 23rd June 2016 referendum date, and the perceived effect of Boris Johnson's support to the leave vote campaign confirms this view.

The chart below shows the GBP-USD exchange rate over last 6 days (February 16th to midday on February 22nd). The Pound has lost more than 2% today (22nd February) and is dropping sharply as this report is being finalised.

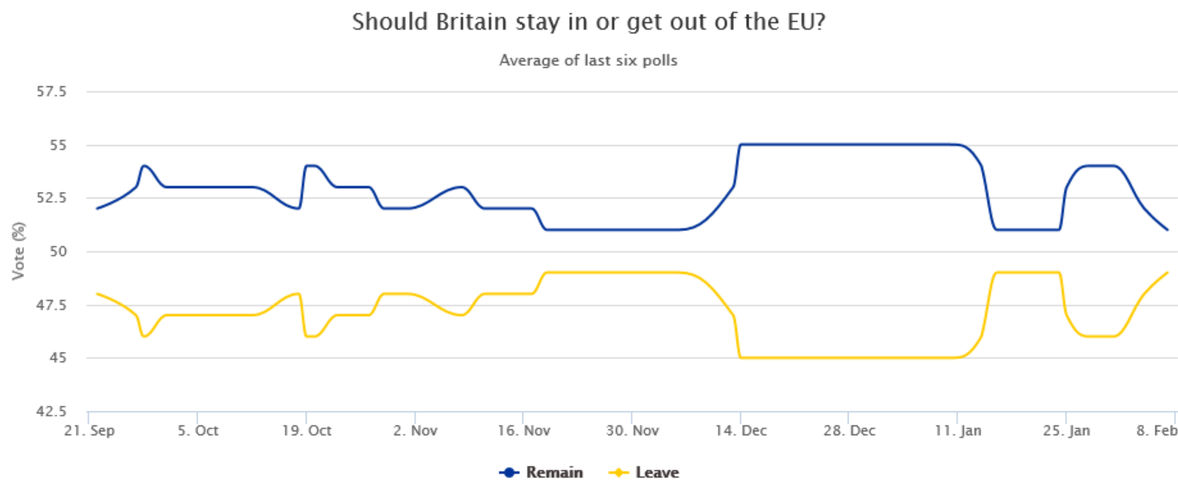


Source: Bloomberg

In the event of the stay vote winning the referendum, GBP could see sharp appreciation and that would be strongly negative for UK investors of Global Equities.

In light of the above, it is imperative that any hedge ratio be considered as a function of the probability of a stay vote winning the referendum. That is, the higher the chance of a stay vote, the higher should be the hedge ratio (this of course assumes that the opinion polls/indicators attempting to "predict" the outcome is proved correct).

For quite sometime, the polls were close but the stay campaign had an edge over the leave as can be seen in the chart below:



Source: What UK Thinks

However, in the last few days, sentiment has shifted and the leave faction has gained significant momentum over the stay campaign. As with any opinion poll, there is always the risk of some margin of error (as seen in the UK General Election polls) and it wouldn't be prudent to base decisions on them unless (potentially) there emerges a significant difference between the two vote outcomes. Even then, it is difficult to predict with any great certainty how a vote may go given the particular emotion that is often attached to matters concerning opinion polls in respect of the EU.

As has been seen in the immediate aftermath of the EU referendum announcement, markets can react very strongly and would probably overshoot the eventual equilibrium level in both momentum and sentiment driven rallies. Even though any depreciation in GBP is positive for Sterling investor of Overseas assets (such as Global Equities), a call to hedge exposure could be made if GBP depreciates very sharply beyond reasonable levels to lock in the gains.

We summarise our thoughts as follows:

- Depreciation of GBP in the event of Brexit could be positive for Sterling investors holding Overseas assets
- If the leave vote were to get ahead in the polls, a reduction in the hedge ratio could be advisable
- However, UK political opinion polls have been notoriously inaccurate in recent years and can not be relied upon completely
- If GBP falls sharply beyond reasonable levels, a hedge could be useful in locking in the gains
- If the stay vote were to win the referendum, GBP could witness a sudden and sharp appreciation which is strongly negative for the investor holding Overseas assets. In this scenario, one could consider increasing the hedge ratio as GBP has depreciated reasonably significantly in recent months
- As things stand there is no reason to alter the hedge ratio from the current 50% position against the major global currencies

5 CONCLUSION

A summary of the main points raised in this paper is shown below:

- Brexit fears have weighed on markets and GBP has experienced weakness against major currencies in recent months
- Despite the Prime Minister's belief that he has negotiated a relatively successful EU negotiation, this has done little to improve sentiment as markets continue to play safe ahead of the referendum reflected in the sell off of Sterling and a rise in UK Gilt yields
- Any uncertainty leading up to the EU referendum is likely to weaken GBP which is positive for UK investors holding Overseas assets
- If the stay vote campaign takes a significant lead, the Fund's hedge ratio could be revised upwards of the existing 50% to protect Overseas assets from a strengthening GBP
- In the event that the leave vote campaign were to obtain a significant lead in the polls, the Fund could consider decreasing the hedge as a weakening GBP would add to the returns from the Overseas assets
- In the lead up to the referendum, financial markets are likely to be volatile - if GBP depreciates sharply in sentiment driven trading beyond reasonable levels, an increase in the hedge ratio beyond 50% could be used to lock in gains from a very weak GBP
- However, in the absence of any clear decision as to the result of the EU referendum we believe that the Fund's existing 50% hedge against the global currency majors (USD, Euro and Yen) remains a sensible position

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