COMMITTEE: Pensions Committee	DATE: 21 July 2011	CLASSIFICATION: Unrestricted	REPORT NO PC/004/112.	AGENDA NO.
REPORT OF: Corporate Director of Resources ORIGINATING OFFICER(S): Oladapo Shonola – Chief Financial Strategy Officer		TITLE: Report on Use of Derivatives Ward(s) affected: N/A		

Lead Member	Cllr Anwar Khan, Chair of Pensions Committee
Community Plan Theme	All
Strategic Priority	One Tower Hamlets

1. SUMMARY

1.1 This report highlights to Members the use of derivative contracts by investment managers to minimise exposure of Pension Fund assets to currency risk and ensure optimum portfolio efficiency.

1.2 The pension fund strategy has been agreed by the Members in the past to ensure that future liabilities of the Fund can be discharged as they fall due. As part of the continuous performance management, the fund strategy is periodically reviewed.

1.3 As decisions have been taken about investments in the past, the Pensions Committee has been made aware of the use of derivatives in the Fund. However, in the interests of enhanced governance, the Council's external auditors have asked officers to provide Members with a more detailed report on this subject. Therefore, this report seeks to give a fuller briefing on derivatives, their purpose and use by the Funds investment managers.

1.4 A number of investment managers are permitted under the conditions of investment agreed during the contract award process to use derivatives in the form of forward foreign exchange contracts to manage exposure to currency risk as part of an overall strategy to ensuring efficient management of fund assets.

1.5 To this end, managers are permitted to use forward foreign exchange contracts, but are also restricted in the use of such financial instruments to mostly cover currency risk. Pension Fund investment managers are not permitted to indiscriminately speculate (i.e. hedge fund type activity) in order to make a profit when using forward contracts, but as a tool to minimise risk and optimise portfolio performance. Therefore, forward foreign exchange deals are not traded primarily for profit, but to minimise currency risk exposure.

2. DECISIONS REQUIRED

2.1 Members are recommended to note the contents of this report.

3. REASONS FOR DECISIONS

3.1 There are no decisions to be made as a result of this report. The report is written to inform committee members of how some investment managers have been permitted, under the terms of their contract with London Borough of Tower Hamlets Pension Fund, to use derivative contracts to manage exposure to currency risk.

4. ALTERNATIVE OPTIONS

4.1 Members can instruct investment managers to not cover currency risk using forward foreign exchange contracts, but that is likely to have a significant impact on the security of fund assets. This is also likely to introduce considerably more volatility into the portfolio of assets.

4.2 If this option was to be taken, it is likely to lead to more indirect loss of value of asset due to currency movement between Sterling and other currencies that investment managers trade in. Consequently, the investment strategy will need to be revised to cover this shortfall which would mean taking more risk in the types of assets that the Fund invests in.

4.3 Another consideration is to what extent Members can instruct investment managers to refrain from using derivatives without such an instruction leading to the termination of the contract. Of the 5 mandates that currently use derivatives, 4 are pooled funds. Where the pension fund is invested in a pooled fund it will not be able to operate a strategy specific to London Borough of Tower Hamlets Pension Fund (e.g. no trading in derivatives) that is different to the investment manager's overall investment strategy.

4.4 This complication means that should Members choose to instruct investment managers not to use derivates these 4 mandates will likely be terminated.

5. BACKGROUND

5.1 The Pension Fund Regulations require that the Council establish arrangements for monitoring the investments of the Fund and the activities of the investment managers and ensure that proper advice is obtained on investment issues.

5.2 This report is supplementary to the regular report that is presented to this Committee on a quarterly basis and deals specifically with the issue of the use of derivatives to manage pension fund assets.

5.3 At the last audit of the Pension Fund, the Council's external auditors reviewed the accounting and reporting of derivatives in the Fund. They recommended that to enhance governance, Members should be made aware that investment managers employ derivatives within their mandates/ allocated assets.

5.4 Officers made it clear to the auditors that Members were already aware of this as it is embedded in our processes as part of regular discussions with Members.

5.5 Members are briefed when a new mandate/asset allocation is made within the Fund. So for example, the papers that went to Members in 18 November 2009 on the establishment of an Absolute Return (Equity) mandate talks explicitly about the use of derivatives to manage any allocation to this asset class. The report stated that:

> *"…some manager will use derivatives to 'hedge' or control exposure to market risk, these products are generally long-only in intent. They often have an equity bias, do not employ gearing and are transparent in nature."*

5.6 In the same paper to Members on 18 November 2009, the following comment was made regarding the manner in which Ruffer (Absolute Return Mandate Manager) uses derivatives

> *"Derivatives are used only for currency positioning or to hedge currency exposure through forward currency contracts."*

5.7 Where derivatives has had a significant impact on a manager's performance, this is reported to Members through the quarterly monitoring process as was the case on 17 February 2011 report which stated that:

> *"Investec will use derivatives to benefit both from rising and falling global bond markets…"*

5.8 On the other side of the coin is Schroder's policy of not entering into forward foreign currency contracts to cover non sterling positions, which has often impacted on their performance. This is an issue that Schroder's actively manages and has been discussed at Investment Panel with Members on a number of occasions.

6 DERIVATIVES

6.1 A derivative is defined as a financial instrument whose value depends on other…underlying variables such as underlying assets…volatilities, etc. The main categories of derivatives are futures, options and swaps. The Fund's investment managers trade in futures to cover a position they have taken in the market.

6.2 Although, there are those that bet on certain outcomes (i.e. speculate in order to profit), this is not an investment strategy that is used by the Fund's investment managers and where derivatives are used for purposes other than for covering market positions/mitigate risk they are used within the scope of the mandate – that is as a tool to enhance the portfolio.

6.3 The 2009-10 annual statement of accounts breaks down the funds exposure to forward foreign exchange contracts as at the 31 march 2010. This showed that the transactions entered into by the funds investment managers had a net positive effect on the overall value of the Fund.

6.4 There are certain asset classes within the London Borough of Tower Hamlets' Pension Fund that intrinsically need the flexibility provided by derivatives to optimise portfolio efficiency. The extent to which these instruments can be utilised are restricted by the fund management contract between the investment manager and the Pension Fund.

6.5 To illustrate why it is often necessary to take out a forward foreign exchange contract to cover currency risk as part of a comprehensive investment strategy, take an equity stock that has performed reasonably well through the year (i.e. increased in value/return). Although, such a stock could have made solid gains in its local currency, any gains arising from such stock value appreciation locally would be eroded if the local currency has decreased in value relative to Sterling (£). Therefore, the flexibility that derivatives in this instance affords investment managers as a tool for 'hedging' risk is critical to the effectiveness of investment strategy.

6.6 Managers need to be accountable for the entirety of their investment strategy and they need certain level of freedom to be able to do this. The conditions of investment agreed with investment managers set boundaries around how derivatives can be used and the funds investment managers are explicit in their policies on the use of derivatives as a tool for managing risk and enhancing portfolio efficiency.

6.7 The 5 mandates that currently use derivatives as part as part of an overall investment strategy are listed in the below table.

Manager's Name	Asset Class	Type of Fund
GMO	Global Equity	Non-pooled
Baillie Gifford	Global Equity	Pooled
Ruffer	Absolute Return	Pooled
Baillie Gifford	Absolute Return	Pooled
Investec	Global Bonds	Pooled

6.8 Finally, it is worth noting that the way that the funds investment managers use forward foreign exchange contracts ensures that any exposure to these instruments are limited to the margins in the contract to buy or sell a particular currency.

6.9 As an illustration of the low level of exposure to these financial instruments within the overall portfolio, all forward foreign exchange contracts would have resulted in a net increase of £740k in the value of fund assets worth nearly £500m as at 31 March 2010 were these assets to be realised. This equates to 0.0015% of the affected assets.

7. COMMENTS OF THE CHIEF FINANCIAL OFFICER

7.1. The comments of the Corporate Director Resources have been incorporated into the report.

8. CONCURRENT REPORT OF THE ASSISTANT CHIEF EXECUTIVE (LEGAL)

8.1 One of the functions of the Pensions Committee is to meet the Council's duties in respect of investment matters. It is appropriate, having regard to these matters, for the Committee to receive information about asset allocation and the preservation of Fund assets.

8.2 The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 require the Council, as an administering authority, to invest fund money that is not needed immediately to make payments from the Pensions Fund. The Council is required to have a policy in relation to its investments and a Statement of Investment Principles and to invest in accordance with these.

8.3 The Management and Investment of Funds Regulations specify that the term investment has its normal meaning. They also make clear that a contract entered into in the course of dealing in financial futures or traded options is an investment. The Regulations place percentage restrictions on types of investments, but these do not appear to relate to derivatives, with the exception that no single investment should exceed 10% of the fund. The percentage of the fund in derivatives is significantly below this.

9. ONE TOWER HAMLETS CONSIDERATIONS

9.1 Any gains or losses arising from the use of derivatives contracts could impact on the Council through an increase or decrease in contributions in order to make good the Pension Fund’s commitment to honour benefits that have been accrued by members of the Fund.

9.2 A viable pension scheme also represents an asset for the recruitment and retention of staff to deliver services to the residents.

10. SUSTAINABLE ACTION FOR A GREENER ENVIRONMENT

10.1 There is no ‘Sustainable Action for A Greener Environment’ implication arising from this report.

11. RISK MANAGEMENT IMPLICATIONS

11.1 The use of any form of investment inevitably involves a degree of risk. Although, the use of derivative contracts is a means to reduce exposure to currency risk that the Fund.

12. CRIME AND DISORDER REDUCTION IMPLICATIONS

12.1 There are no crime and disorder reduction implications arising from this report.

13. EFFICIENCY STATEMENT

13.1 The use of derivate contracts is an efficient use of financial instruments that helps to minimise risk to Pension Fund assets and also maximise returns.

LOCAL GOVERNMENT ACT 1972 (AS AMENDED) SECTION 100D
LIST OF "BACKGROUND PAPERS" USED IN THE PREPARATION OF THIS REPORT

Brief description of "background papers"	*Name and telephone number of holder And address where open to inspection*