Nottinghamshire County Council

Report to Pension Fund Committee

1 September 2022

Agenda Item: 9

REPORT OF THE SERVICE DIRECTOR – FINANCE, INFRASTRUCTURE & IMPROVEMENT

DERIVATIVES USE IN SCHRODERS ACTIVE EQUITIES AND LGPS CENTRAL GILTS SEGREGATED MANDATES

Purpose of the Report

1. To approve the use of derivatives in the Schroders Actives Equities and LGPS Central Gilts segregated mandates for the purposes of efficient portfolio management.

Information

2. As recorded in the Investment Strategy Statement, the Pension Fund is permitted to invest in a wide range of assets and strategies, which includes using derivatives. However the Fund will not invest directly in derivatives, including currency options, without the prior approval of the Pension Fund Committee.

3. Both Schroders and LGPS Central believe it would be beneficial to the performance, cost and efficiency of the mandates if such derivative use was permitted. For both mandates use would be for the purpose of efficient portfolio management only.

4. Schroders proposes to use derivatives to adjust equity and currency exposures. Specifically, exchange traded equity index futures may be used to adjust equity exposure whilst forward foreign exchange contracts may be used to adjust currency exposures. In the case of equities, exchange-traded futures are centrally cleared and, as such, have minimal counterparty risk. In the case of FX forward, these are implemented through over-the-counter (“OTC”) instruments, where counterparties are solely those approved by Schroders’ credit and risk teams.

5. Both equity and currency derivatives may be used to increase or decrease exposures to equities / currencies, either for hedging purposes or to efficiently implement overweight positions, subject to three limitations:

   a. The net exposure of physical regional positions and derivatives will be limited to a maximum 3% above or below the benchmark (for example, if the Japan weight within the benchmark is 3.5% then the Japanese equity and Yen exposures are bounded between 0.5% and 6.5%);

   b. Derivatives may not be used to create a net short in an equity region or currency (for example, if the Australia weight within the benchmark is 1% then the manager may not sell more than 1% of Australian equity index futures or AUD FX forwards to create a net short);

    c. Derivatives may not be used to increase net market exposure above 100% (for example if the portfolio owns 99% in physical equities then the manager cannot buy more than a net 1% in equity index futures as that would take net exposure above 100%).

6. In all cases, the manager may assume that the exposures of the regional subportfolios are in line with benchmark. This will ensure that the Schroders Multi-asset team do not hedge-out intentional stock selection tilts implemented by the regional equity managers.

7. Use of these derivatives would enable Schroders to implement Tactical Asset Allocation views on regional equity markets in a way which is much cheaper and quicker to execute than to deal in pooled funds or individual equities, and without disturbing regional equity sub portfolios managed by Schroders regional equity team.

8. LGPS Central proposes to use Exchange Traded UK gilt futures only, and use is limited to 20% of the total portfolio notional value.

9. Use of gilt futures would enable the Fund to access additional liquidity and short-term positioning at reduced cost compared to holding the underlying investments. LGPS Central would use this capability to better manage duration risk

10. The practical operation of derivative use will need to be confirmed with both managers to ensure it can be implemented within our current resourcing.

11. Use of derivatives in this way is standard industry practice.

Financial implications

12. The costs of using these financial instruments as an overlay to the portfolio will be cheaper than achieving the same market exposures solely through holding the underlying investments.

13. Implementation will be carefully controlled to minimise risk.

14. The Investment managers believe that performance after costs would be enhanced through the use of derivatives.

Other Options Considered

15. There is no requirement to use derivatives, but our investment managers believe the Pension Fund mandate performance after costs would be enhanced by including this option.

Reason/s for Recommendation/s

16. The use of derivatives in these mandates for efficient portfolio management enables investment managers to better implement their tactical market views.

Statutory and Policy Implications

17. This report has been compiled after consideration of implications in respect of crime and disorder, data protection and information governance, finance, human resources, human rights, the NHS Constitution (public health services), the public sector equality duty, safeguarding of children and adults at risk, service users, smarter working, sustainability and the environment and where such implications are material they are described below. Appropriate consultation has been undertaken and advice sought on these issues as required.

RECOMMENDATION/S

1. Nottinghamshire Pension Fund Committee approves amendments to the investment mandates for these two segregated mandates to permit the use of derivatives as set out in the report for the purposes of efficient portfolio management.

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Service Director for Finance, Infrastructure & Improvement

For any enquiries about this report please contact: Tamsin Rabbitts
Constitutional Comments (KK 19/08/2022)

18. Nottinghamshire Pension Fund Committee is the appropriate body to consider the content of this report.

Financial Comments (TMR 18/08/2022)

19. The financial implications are included in the report.

Background Papers and Published Documents

Except for previously published documents, which will be available elsewhere, the documents listed here will be available for inspection in accordance with Section 100D of the Local Government Act 1972.

- None

Electoral Division(s) and Member(s) Affected

- All