JAGGER & ASSOCIATES

Investment Update
November 2011

Investment Headlines & Comment

- Record lows for **ILG yields**, with negative yields across the curve to 2062 (which is now on -0.04%).
- More **Euro chaos** - yield margins over Germany have hit new highs for Italy, Spain … and Belgium!
- **Cash (**3-month LIBOR) is back above 1%, and gilt yield falls have led to increased credit spreads.

Feature Section

This month, we consider a tool used by some investment managers to perk up their returns – stock lending. Certain aspects are contentious for investors and are thus worth some discussion here. We are grateful to Legal & General Investment Management for permission to quote their helpful briefing materials (but we are responsible for having edited some bits to fit our available space!).

L&G: Stock Lending involves an asset owner temporarily passing the title of that asset to a borrower (while keeping economic exposure) in return for a fee and against collateral. There are two key motivations for securities lending. The first involves a need, typically from market participants such as investment banks, for physical equity or fixed income securities to facilitate certain trading operations such as avoiding a failed settlement, facilitating a 'short' position or taking advantage of cross-border arbitrage opportunities. The second is to make assets work harder for their owners, by receiving a fee for effectively "letting" the investment.

J&A: Critics claim securities lending facilitates short-selling, making market declines more severe, but some (but not all) academic research suggests the opposite. Unsurprisingly, the International Securities Lending Association (ISLA) asserts that short selling actually ensures prices adjust more quickly to new information, decreasing the likelihood of price bubbles, and even leads to higher market levels as investors have greater confidence that prices reflect fair value. The Financial Services Authority (FSA) stated in 2008 that short selling is a legitimate investment activity which can support efficient markets, but they have subsequently introduced some disclosure requirements.

L&G: It is not acceptable to allow an environment where short selling may be abused by some market practitioners and this is what the FSA and other regulators seek to curtail. Transparency should be at the heart of any solution. (***J&A:*** The EU's proposed rules to ban some short selling are currently facing legal action by the UK.)

L&G: In stock lending, a lender basically faces three types of risk:
Counterparty risk - the borrower may default while in possession of the securities. This risk can be mitigated (but not totally eliminated) by lending to the "right" counterparty and against the "right" collateral. However, it is imperative that the asset owners have a clear understanding of and agree with how their agents define "right" in this context. Problems experienced by some lenders in the market turmoil of 2008 were primarily caused by accepting the wrong type of collateral and / or the wrong type of counterparty.

There should be limits on the proportion of a fund and individual securities which may be on loan at any point in time. There should also be a cap at the fund level on the exposure to each counterparty.

Corporate governance risk - the loss of voting rights during the period of the loan. Right of recall should exist in contracts with all counterparties so that managers can exercise voting rights on behalf of clients (***J&A:*** there is a risk of slow return, and in theory a borrower could borrow simply to be able to vote on a specific issue).

Inappropriately rewarded risk - conflicts of interest may exist between the lender and its agent. For example, if the risk is borne by the lender while the revenue is shared between the lender and its agent, this could potentially encourage the agent to compromise on the quality of both the collateral and the counterparty.

J&A: We agree managers need to avoid conflicts of interest between themselves and their clients. Some thus decide that all securities lending revenue "net of administrative charges" should go to the relevant fund for the exclusive benefit of clients. Other managers claim it is difficult to identify what administrative charges should be fair, and hence a 70:30 or 60:40 investor : manager split of proceeds may reasonably be used instead.

L&G: Securities lending should be undertaken only in markets with a well-established securities lending market, where the expected return considerably outweighs the risk involved, and where the risk can be controlled effectively. No compromises should be made in terms of the quality of either the collateral or the counterparties (who should meet or exceed specified short-term credit ratings). Collateral should be limited to G7 (ex Italy) government bonds and AAA rated supranational bonds, with (say) 105% coverage. Cash collateral should be avoided - the lender is obliged to compensate the borrower for the cost of carry on the collateral. This could lead the lender into taking unnecessary risk to generate a return on the cash which is at least on a par with its obligation to the borrower.

J&A: Overall, if run properly, we do not see stock lending as high on clients' worry lists. Do readers agree?

Asset Returns and Financial Measures [*in Sterling unless marked otherwise*]

The cells in bold with light shading show the best and worst performing asset classes from each column. The commodities and $-based and unhedged-£-conversion hedge fund returns are excluded from that.
[**NB** Future returns cannot be inferred from this table alone, but coupled with other items within *Update*, readers can make inferences as to whether they should be higher or lower than the past returns shown below.]

Table 1: Investment Data to 30 November 2011

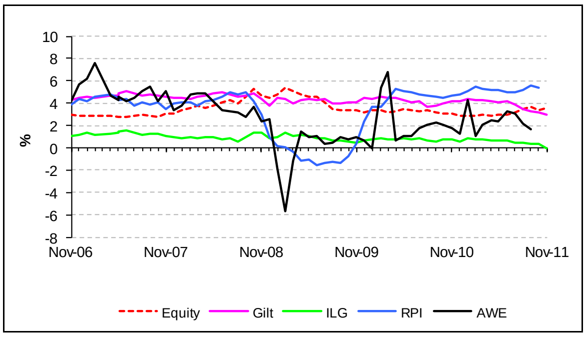
Asset Class	1 month (%)	3 months (%)	12 months (%)	3 years (% p.a.)	5 years (% p.a.)	10 years (% p.a.)	20 years (% p.a.)
UK Equities	-0.4	2.1	2.6	13.9	1.7	4.7	8.2
Overseas Equities	-0.5	0.4	-1.5	13.2	4.0	4.0	7.4
US Equities	2.3	6.4	6.5	13.4	4.6	2.1	8.9
Europe ex UK Equities	-2.9	-4.1	-5.9	9.2	0.2	4.8	8.9
Japan Equities	-1.9	-2.7	-8.6	3.3	**-1.9**	**1.3**	**0.2**
Pacific ex Japan Equities	**-5.3**	**-6.6**	-10.4	23.7	9.3	12.1	9.1
Emerging Markets	-4.2	-6.5	**-12.2**	22.9	8.6	**14.1**	9.3
UK Long-dated Gilts	4.6	**14.5**	**25.1**	11.4	7.9	6.8	**9.5**
UK Long-dated Corp. Bonds	-0.9	4.2	10.5	12.3	4.4	5.6	-
UK Over 5 Yrs Index-Linked Gilts	**7.2**	11.8	23.6	15.2	8.8	8.1	8.4
High Yield (Global)	-0.7	1.8	1.9	**24.9**	11.7	7.6	-
Overseas Bonds	1.4	0.8	6.2	6.2	**12.2**	6.5	7.4
Property *	0.6	1.9	8.7	4.0	-1.2	6.6	8.4
Cash	0.1	0.2	0.9	**1.0**	3.0	3.7	5.2
Commodities £-converted	3.3	0.5	8.6	1.6	0.4	4.6	4.1
Hedge Funds original $ basis *	2.6	-4.4	-0.4	7.6	3.3	6.5	10.9
Illustrative £-converted version *	-0.9	-2.8	-1.3	7.7	6.9	5.4	11.3
Euro relative to Sterling	-0.9	-3.2	2.4	1.2	4.9	3.1	-
US $ relative to Sterling	2.6	3.5	-1.0	-0.9	4.6	-1.0	0.6
Japanese Yen relative to Sterling	3.1	2.0	6.9	6.2	13.3	3.7	3.2
Price Inflation (RPI) *	0.0	1.4	5.4	3.0	3.5	3.2	2.9
Price Inflation (CPI) *	0.1	1.3	5.0	3.2	3.2	2.5	2.2
Price Inflation (RPIX) *	0.0	1.5	5.6	4.0	4.0	3.2	3.0
Earnings Inflation **	0.3	-2.2	1.7	1.7	2.6	3.2	3.6
All Share Capital Growth	-0.9	1.3	-0.9	9.9	-1.9	1.2	4.5
Net Dividend Growth	5.7	4.2	14.2	0.4	1.8	4.3	-
Earnings Growth	9.6	-2.0	24.8	6.4	5.6	9.5	-

Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

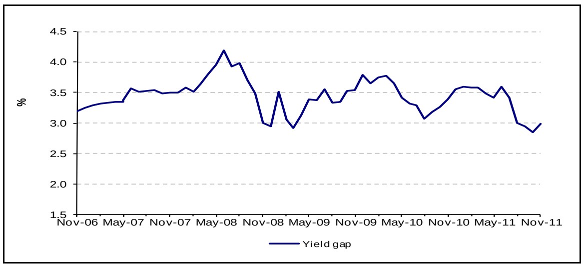
- *UK Equities (incl. dividends and earnings) – FT-A All Share.*
- *Overseas Equities (incl. regions) – blend of FT All-World / World subindices*
- *Emerging Markets from MSCI US $ based total return index (overall Index to 31 Oct 2001, Free Index from 1 Nov 2001 to take account of foreign investment restrictions), conversion to UK £ by J&A.*
- *UK Bonds – FT-A indices (Gilts Over 15 Years, ILG Over 5 Years)*
- *UK Corporate Bonds – iBoxx Non-Gilt **Over 15 Year** index (all credit ratings combined)*
- *High Yield – Merrill Lynch Global, £ Unhedged*
- *Overseas Bonds – JP Morgan Traded Unhedged World ex UK*
- *Property – IPD Monthly Index*
- *Commodities – GSCI Total Return, converted to UK £ by J&A*
- *Hedge Funds Composite – HFRI US $ based total return index plus converted to UK £ by J&A. **NB A smooth "cash+x%" return will only be shown in the base 'hedged' currency, here the US $.***
- *Cash – an indicative index based on the three-month London Interbank Sterling mid-rate, calculated internally by J&A*
- *Price and earnings inflation – RPI, CPI, RPIX, and Average Weekly Earnings (whole economy, not seasonally adjusted, latest provisional data)*
- *Currency data – London close, from the Financial Times*
- ** denotes data lagged by 1 month, ** by 2 months – these reflect the later publication dates of these data items.*

Yields and Yield Gaps

Figure 2: Yields, Inflation and Yield Gaps



The yield gap is a measure of expected average future inflation, derived as long bond yield minus ILG yield.

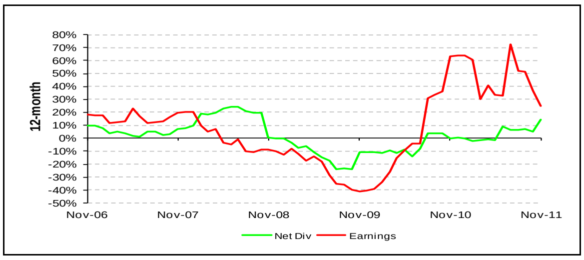


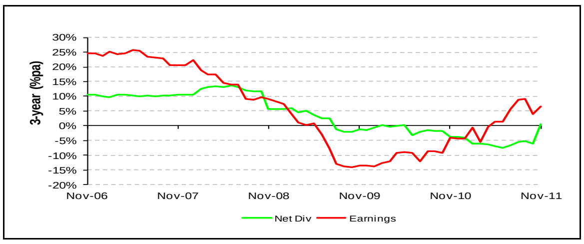
The gap gives expectations now nudging back towards 3% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

Growth in Earnings and Dividends

These charts show movements in rolling 12-month and 3-year dividend and earnings growth for UK Equities over the last 5 years. [*NB the charts have different scales*]

Figure 3: Dividend & Earnings Growth

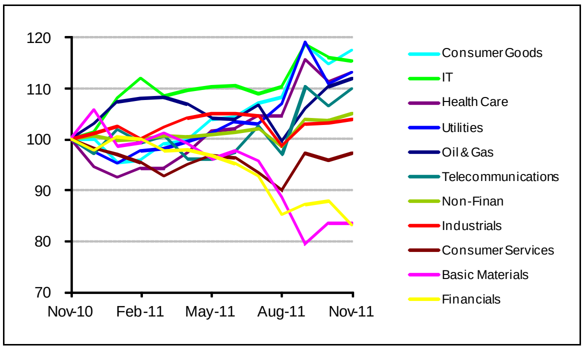




Sources for charts on this page:
Financial Times, Office for National Statistics, J&A

UK Equity Sector Returns

Figure 4a: Sectors relative to All Share



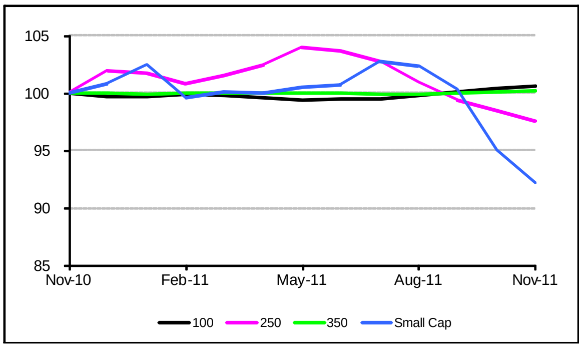
Note: Sector labels for relative lines are in end-value order

There was a rise this month in the rolling 12-month sector dispersion (up from 30% to 34%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	1.1	9.5	14.9
Basic Materials	-0.5	-8.2	-14.4
Industrials	0.2	2.4	6.5
Consumer Goods	2.0	5.6	20.5
Health Care	1.3	5.2	16.0
Consumer Services	1.0	5.2	-0.3
Telecommunications	2.9	10.2	12.8
Utilities	1.7	3.0	16.0
Non-Finan	1.1	4.0	7.9
Financials	-5.9	-5.1	-14.8
IT	-0.9	1.8	18.5
All Share	-0.4	-2.7	2.6

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Small and Mid Cap both fell in relative terms this month.

FRS17 volatility indicator

Now discontinued, but available on request.

Investment Update
November 2011

Bond market information

Sources: Barclays Capital, DMO, iBoxx, J&A, MLX

Figure 5: £ Non-Gilt Credit Margins

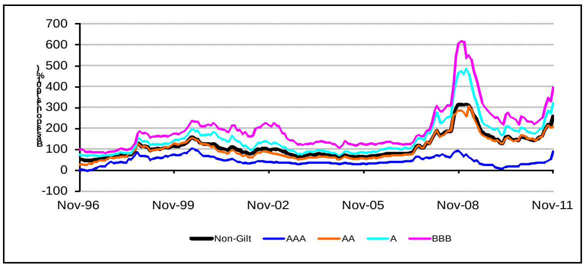


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
June 11	5.54	4.21	1.33
July 11	5.21	3.87	1.34
Aug 11	5.30	3.68	1.62
Sep 11	5.06	3.25	1.81
Oct 11	4.89	3.19	1.70
Nov 11	**4.81**	**2.95**	**1.86**

Tables 2b, 2c: £ Market Size and Maturity

Category	Mkt Val (£bn @ Nov 11 & 09, 07)			Weight (%)
	Nov 11	09	07	
Gilts (35)	981	705	335	67.8
Non Gilts (1,015)	466	487	429	32.2
AAA (171)	128	152	159	8.9
AA (155)	68	66	66	4.7
A (388)	164	169	133	11.3
BBB (301)	106	97	68	7.3

Category	Mkt Val (£bn @ Nov 11, 09)		W't (%)	Dur'n (yrs)
	Nov 11	09		
Gilts (35)	981	705	67.8	9.9
< 5 Yrs (9)	277	206	19.2	2.9
5–15 Yrs (11)	313	232	21.6	7.2
> 15 Yrs (15)	392	267	27.1	17.1
Non Gilts (1,015)	466	487	32.2	7.6
< 5 Yrs (267)	123	153	8.5	2.6
5–15 Yrs (469)	198	195	13.7	6.8
> 15 Yrs (279)	145	139	10.0	13.0

£ Gilt Market "main" Issuance

- £4.00bn 5% 2018 (1.92x, 1.43%, prev Feb 10)
- £2.00bn 4¼% 2032 (1.63x, 3.11%, May 10)
- £3.50bn ILG $^{1}/_{8}$% 2029 (2.86x, r.y 0.09%, new)
- £0.99bn ILG $^{5}/_{8}$% 2040 (2.61x, r.y 0.24%, Jun 11)
- CPI Gilt issuance **not** proceeding in 2012-13

Note: Issuance amounts are nominals.

Tables 2d, 2e: € Market Size and Maturity (Nov 11)

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (249)	3,913	57.3
Non Sovereigns	2,913	42.7
AAA (643)	1,247	18.3
AA (414)	581	8.5
A (695)	704	10.3
BBB (485)	380	5.6

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (824)	2,018	29.6
3 – 5 Yrs (656)	1,553	22.8
5 – 7 Yrs (407)	910	13.3
7 – 10 Yrs (389)	1,231	18.0
10+ Yrs (210)	1,113	16.3

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Oct 11 & 09)		W't (%)	Dur'n (yrs)
	Oct 11	09		
Gilts (19)	325	215	92.0	17.2
< 5 Yrs (2)	49	35	13.9	3.2
5 – 15 Yrs (4)	85	85	24.1	8.8
> 15 Yrs (13)	191	96	54.0	24.6
Non Gilts (47)	28	22	8.0	17.9

Table 2g: High Yield bond yields (BB-B indices)

Month End	US (%)	Euro (%)	Sterling (%)
July 11	6.93	7.52	8.92
Aug 11	7.82	9.25	10.26
Sep 11	8.65	10.58	11.27
Oct 11	7.62	9.05	10.31
Nov 11	**8.10**	**10.98**	**11.69**

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