JAGGER & ASSOCIATES

Investment Update
May 2011

Investment Headlines & Comment

- The **PPF** has confirmed the incorporation of **investment risk** into its levy calculation – see our November 2010 *Update* for the consultation background.
- The PPF claim this is not meant to influence a scheme's investment decisions, but that is just not a remotely credible stance to take. Expect more disasters to emerge.
- Given that background, it is worth noting that **Index-Linked Gilts** (ILGs) are back near their record low real yields seen in mid 2010. Could PPF send them even lower?

Feature Section

In last month's *Update* news we wondered at Silver's 37% year-to-date (YTD) rise – only for it to fall dramatically in the following week (though by the end of May it was still up by some 25% YTD). The longer term total returns for overall Commodities remain in low single figures (see Table 1 on page 2), but with high volatility at well over 20% p.a. So, this month's feature considers how much volatility there is within the various Commodities sectors (all data is courtesy of Goldman Sachs), and whether investors should thus be looking at moving between sectors, rather than investing in the asset as a whole.

We last featured Commodities in our March and April 2006 editions (available on our website). The main reminder needed here is that there are two ways of getting Commodities returns– one is based on investing in them at current market prices ("spot"), and the other is based on using futures to make the investments ("total return").[1] Figure 1a shows the cumulative growth since 1982 for the two approaches (1982 is the earliest point that full underlying sector data applies). Over the full period, "total return" has beaten "spot" by about 3% p.a. *but* over the last 20 years the reverse has applied, with "spot" 2.5% p.a. ahead – being clever with derivatives does not always pay off. Figure 1b considers the absolute "spot" returns for the 5 main sectors within the GSCI, but Figure 1c shows them *relative* to the GSCI (kept at a notional value of 100).

Figure 1a: "Total return" vs "spot" return
(Cumulative from December 1982 = 100)

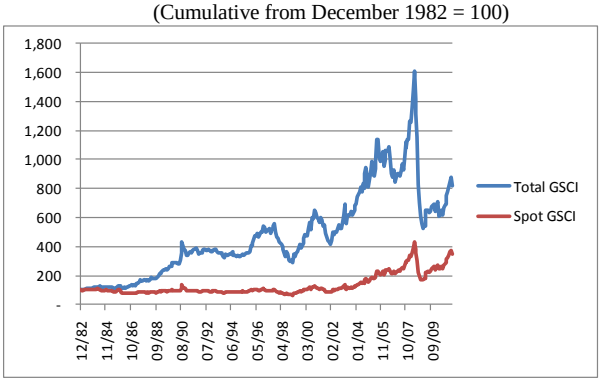


Figure 1b: Absolute results for sectors

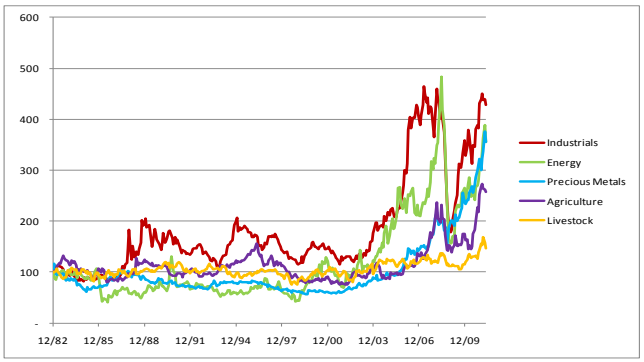


Figure 1c: Relative results for sectors

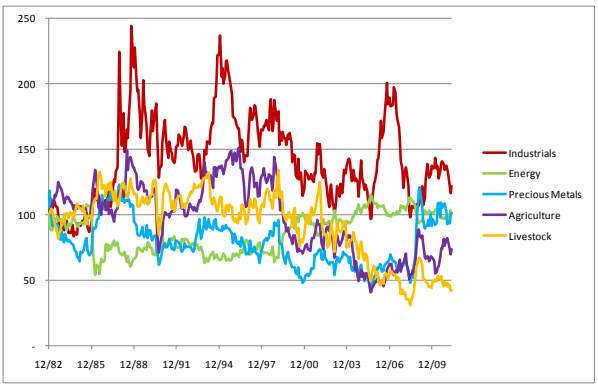


Figure 1b shows just how much of a step change there was in markets in the early 2000s – in late 2002 the cumulative dispersion between best and worst sectors since 1982 was only 50%, but it is now over 280%. (The scale for the "total return" version is even more dramatic.) The GSCI has a bias to the Energy sector, so it is not a surprise that that sector's relative results seem less volatile in Figure 1c, but the severity of the moves in and out of favour for Industrials versus other commodities is noticeable. (For reference, the Industrial Metals only make up 7% of the GSCI, being mostly Aluminium and Copper, with sub 1% weights in Lead, Nickel, and Zinc.)

[1] For example, heavy current demand for a commodity would mean an investor commits to higher prices at fairly short terms, but through futures they might be able to pay lower prices at longer terms ("backwardation"). The return from such an investment is the total of (a) the return on the cash committed for the future purchase (because you retain them until then), (b) the return from moving along the price curve (usually it is a gain because of backwardation), and (c) the effect of any change in the level of the price curve.

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 31 May 2011

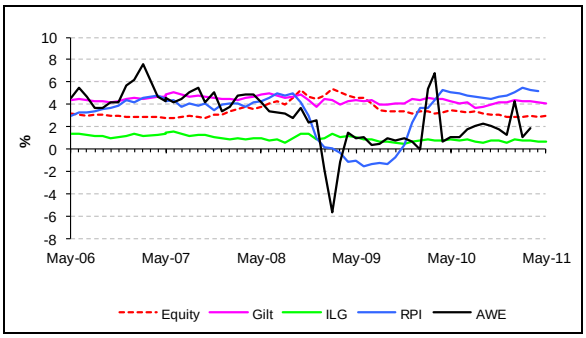
Asset Class	1 month (%)	3 months (%)	12 months (%)	3 years (% p.a.)	5 years (% p.a.)	10 years (% p.a.)	20 years (% p.a.)
UK Equities	-0.7	1.5	20.4	4.1	5.0	4.5	8.6
Overseas Equities	-0.8	0.8	13.2	5.8	7.3	3.8	7.6
US Equities	0.2	0.7	11.2	7.5	6.3	1.3	9.8
Europe ex UK Equities	**-2.6**	3.2	**23.8**	1.6	6.6	5.9	8.8
Japan Equities	-0.4	**-11.2**	**-3.7**	**-1.1**	**-1.9**	**-0.8**	**0.1**
Pacific ex Japan Equities	-0.8	**6.1**	18.3	11.2	**15.5**	13.3	**10.1**
Emerging Markets	-1.3	5.2	14.0	7.8	15.0	**14.8**	9.9
UK Long-dated Gilts	1.4	5.2	7.4	7.7	5.0	5.8	8.9
UK Long-dated Corp. Bonds	0.7	4.2	8.6	8.7	4.2	6.3	-
UK Over 5 Yrs Index-Linked Gilts	**1.6**	4.5	10.8	6.3	6.8	7.0	7.8
High Yield (Global)	1.3	1.8	6.5	**18.9**	12.6	7.6	-
Overseas Bonds	1.4	2.1	-2.0	13.5	10.5	6.4	7.3
Property *	0.7	2.3	9.9	-1.0	-0.3	6.5	8.2
Cash	0.1	0.2	0.8	1.8	3.4	3.9	5.5
Commodities £-converted	-5.6	0.3	18.1	-12.7	-2.4	2.0	4.3
Hedge Funds original $ basis *	1.5	2.9	9.9	4.1	4.9	7.1	11.9
Illustrative £-converted version *	-2.4	-1.2	0.9	10.2	6.8	5.5	12.1
Euro relative to Sterling	-1.8	2.9	3.4	3.6	4.9	3.9	-
US $ relative to Sterling	1.3	-1.2	-11.7	6.3	2.6	-1.5	0.2
Japanese Yen relative to Sterling	1.2	-0.3	-1.0	16.0	9.4	2.4	2.9
Price Inflation (RPI) *	0.8	2.4	5.2	3.1	3.6	3.1	2.9
Price Inflation (CPI) *	1.0	2.1	4.5	3.5	3.2	2.4	2.2
Price Inflation (RPIX) *	0.9	2.4	5.3	4.1	4.0	3.2	3.0
Earnings Inflation **	4.5	12.0	1.9	2.4	3.3	3.8	4.4
All Share Capital Growth	-1.1	0.5	16.8	0.4	1.4	1.1	4.9
Net Dividend Growth	1.0	3.2	-1.2	-6.9	0.1	3.4	-
Earnings Growth	0.6	0.5	33.6	1.3	4.3	7.1	-

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

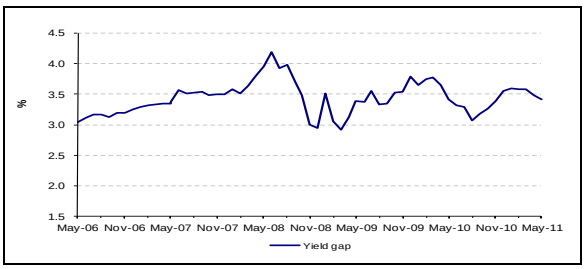
- *UK Equities (incl. dividends and earnings) – FT-A All Share.*
- *Overseas Equities (incl. regions) – blend of FT All-World / World subindices*
- *Emerging Markets from MSCI US $ based total return index (overall Index to 31 Oct 2001, Free Index from 1 Nov 2001 to take account of foreign investment 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.

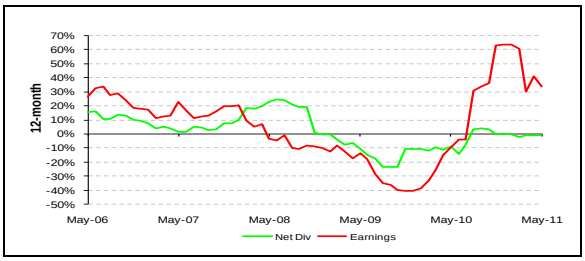


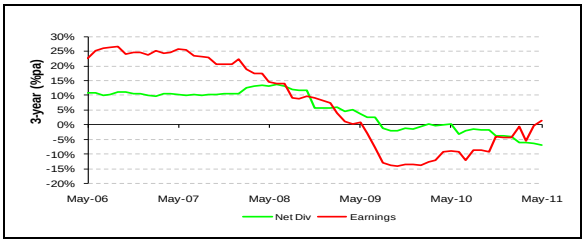
The gap gives expectations of just below 3.5% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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

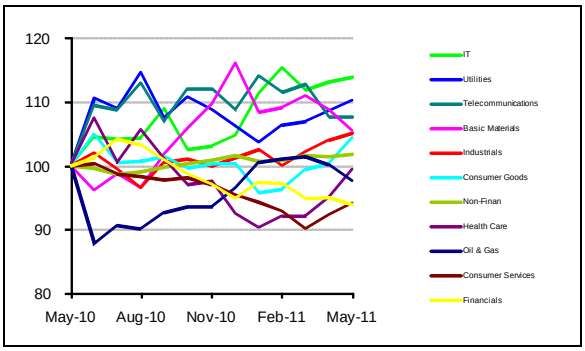




Sources for charts on this page:
Financial Times, Office for National Statistics, J&A

UK Equity Sector Returns

Figure 4a: Sectors relative to All Share



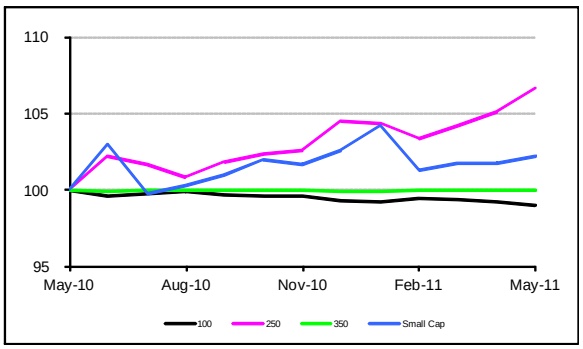
Note: Sector labels for relative lines are in end-value order

There was a fall this month in the rolling 12-month sector dispersion (down from 23% to 20%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	-3.2	-2.0	17.5
Basic Materials	-3.7	-1.8	27.0
Industrials	0.3	6.7	26.6
Consumer Goods	3.4	10.0	25.7
Health Care	3.8	9.5	19.6
Consumer Services	1.2	3.0	13.2
Telecommunications	-0.7	-1.9	29.6
Utilities	0.8	5.1	32.6
Non-Finan	-0.4	2.6	22.7
Financials	-1.9	-1.9	13.0
IT	-0.1	0.2	37.0
All Share	-0.7	1.5	20.4

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Mid and Small Cap rose in relative terms this month.

FRS17 volatility indicator

Now discontinued, but available on request.

Bond market information

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

Figure 5: £ Non-Gilt Credit Margins

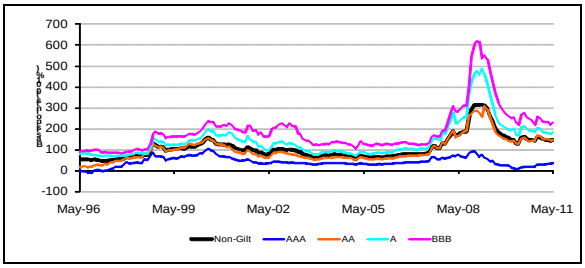


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
Dec 10	5.35	4.14	1.21
Jan 11	5.50	4.39	1.11
Feb 11	5.45	4.31	1.14
Mar 11	5.46	4.31	1.15
Apr 11	5.26	4.14	1.12
May 11	**5.26**	**4.06**	**1.20**

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

Category	Mkt Val (£bn @ May 11 & 09, 07)			Weight (%)
Gilts (34)	833	602	302	63.7
Non Gilts (1,023)	474	422	414	36.3
AAA (178)	129	145	149	9.9
AA (174)	75	57	66	5.8
A (382)	166	144	127	12.7
BBB (289)	104	74	68	8.0

Category	Mkt Val (£bn @ May 11, 09)		W't (%)	Dur'n (yrs)
Gilts (34)	833	602	63.7	9.1
< 5 Yrs (9)	246	177	18.8	2.9
5–15 Yrs (11)	284	206	21.7	7.2
> 15 Yrs (14)	303	220	23.2	16.1
Non Gilts (1,023)	474	422	36.3	7.5
< 5 Yrs (259)	122	150	9.3	2.7
5–15 Yrs (481)	212	159	16.3	6.8
> 15 Yrs (283)	140	114	10.7	12.9

£ Gilt Market "main" Issuance

- £5.00bn 2¼% 2014 (1.67x, 1.46%, prev Sept 09)
- £3.25bn 5% 2025 (1.25x, 3.83%, Mar 09)
- £2.19bn 4¼% 2040 (1.54x, 4.21%, Apr 11)
- £1.31bn ILG $1^{7}/_{8}$% 2022 (2.05x, r.y 0.49%, Feb 11)
- £3.50bn ILG ¾% 2034 (1.83x, r.y 0.79%, new)

Note: ILG issuance amounts are nominals

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

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (265)	4,011	57.9
Non Sovereigns	2,913	42.1
AAA (641)	1,216	17.6
AA (452)	633	9.1
A (646)	675	9.8
BBB (468)	389	5.6

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (760)	1,928	27.8
3 – 5 Yrs (674)	1,607	23.2
5 – 7 Yrs (441)	990	14.3
7 – 10 Yrs (374)	1,179	17.0
10+ Yrs (223)	1,220	17.6

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ May 11 & 09)		W't (%)	Dur'n (yrs)
Gilts (17)	269	179	91.4	16.0
< 5 Yrs (1)	22	33	7.5	2.2
5 – 15 Yrs (5)	104	61	35.3	8.1
> 15 Yrs (11)	143	84	48.6	23.9
Non Gilts (48)	25	18	8.6	17.5

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

Month End	US (%)	Euro (%)	Sterling (%)
Jan 11	6.95	7.39	8.55
Feb 11	6.83	7.18	8.09
Mar 11	6.86	7.57	8.28
Apr 11	6.72	7.20	8.14
May 11	**6.79**	**7.06**	**8.26**

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