# JAGGER & ASSOCIATES

## Investment Update
### *October 2012*

## Investment Headlines & Comment

- A poor month for **Commodities** as the oil price fell by about 7%.
- **LIBOR** has halved in the last six months, nearly back to base rate.
- A **Cambridge University** £350m 40 year bond is over-subscribed.

## Feature Section

This month we welcome a guest contributor, whose blood pressure is rising over the RPI/CPI consultation process. Keith Wallace of the law firm Reed Smith sets out some of his concerns on the debate, and we do our best to get a word in edgeways to comment. (Readers may have noticed a recent letter in the Financial Times by Keith on this subject). Keith's view is that pension schemes have been bullied by Parliament since 1975 to "index" or revalue benefits, and he counts 15 different law changes over the years. Some schemes hard-wired these requirements as a trust right into their deeds. Some did not. Hence in the plethora of differing benefit uplift bases, a further complication arises - are bases scheme-set or statute-set? Keith notes that for revaluation in deferment, scheme-set (RPI) was used in 28% of cases, but 68% simply referred to being statute-set, with 3% doing other things. For pensions in payment, the equivalent figures were 74%, 22% and 3%.

RPI, the index, has roots going back to World War I when it measured what a responsible war-worker needed to live on. Beer was excluded since it was not essential to survival! RPI has spawned variants, RPIX being one, trimming out mortgage interest. Came the Euro, and Brussels' statisticians devised a better constructed index to set all Euro countries a common measure to check they weren't cheating. This, HICP, was renamed CPI (*J&A: see October 2003 Update*). The UK statistical service, ONS, is now consulting on RPI construction changes (*J&A: for example because consumers may change from brand A to brand B rather than bear the full price rise associated with brand A, as RPI currently assumes*). Aligning the methodology towards CPI will reduce reported "inflation" by 0.5% or so a year. For schemes anxious about funding, a reduction in the rate that applies to them dramatically reduces their liabilities. Where the debate has become tangled, in Keith's personal view, is the knee-jerk assumption that such a change to the "RPI" automatically entails a shift in the future rate applied to the capital and interest of index-linked gilts already issued by the Government (ILGs). The "loss" of ½% a year, income and capital on a 50 year ILG would be dramatic (*J&A: if priced in a one-off fall, it would be a fall of about 17%*). Keith offers 10 reasons why this spectre is less likely than feared.

1. All ILGs have "index change" wording when issued: there are actually *four* clause types. A shift with the known order of consequence such as envisaged here can hardly – in Keith's view as a lawyer – be defended as some mere statistical refinement. Hence, applying any variant of RPI to ILGs risks challenge on legal grounds.
2. The Government is wary of suggestions of fiddling, reducing ILG costs by a device - see the 2003 Chancellor's Statement on CPI and the Single Market.
3. Other sterling inflation linked bonds (*J&A see Table 2f on page 4*) piggyback in different ways on the legal terms of ILGs (this improves their marketability). The European Investment Bank is one such issuer. The EIB bonds refer any question of index change to an outside expert who may, for example, award compensation. Imagine the stink if EIB's expert ordered compensation for an index change when the British Government had simply railroaded it through for ILGs.
4. The market punishes governments who rig indices. Take Argentina who issued inflation linked bonds. It then published an inflation index which was publicly ridiculed and which learned journals like The Economist refused even to print. Result – discredited bonds.
5. Property leases, utility franchises, annuities and commercial contracts also use "RPI". This is the measure adopted, with its known characteristics and imperfections. For Government to intrude into this area of private contract would be unjustified and unwise.
6. While an enforced change to "RPI" may help pension scheme funding numbers, that windfall is no consolation whatever to all other ILG holders.
7. In the ONS UK Accounts, pension schemes hold 24.7% of index linked gilts. Other holders may include UK insurers, but consider the rest. Offending "grey power" pensioner voters by intentionally reducing their savings' value is an excellent way to lose an election.
8. From the same source, overseas banks, central banks and sovereign wealth funds account for £70 billion of all gilts (but their percentage of ILGs is not publicly available). These are people you do not short-change.
9. At least one other country (France) issues multiple index linked instruments tied to different indices. (See the *RBS Guide to Inflation Linked Products* for detail.)
10. There are already two classes of ILGs – those with an eight month index lag and later issues with a three month lag. Liquidity hasn't suffered. The Government, through the Debt Management Office consulted last year on issuing CPI linked bonds and seems to recognise that if a wide demand is there, co-existence with a further kind of ILG could be acceptable.

This combination of considerations leads Keith to the view that – whatever the outcome of the current consultation on modernising "RPI" – the "old" RPI used for current index-linked gilts will continue in force. However, J&A would note that even in that case, it does not rule out the basket of goods changing over time.

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## 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 <u>cannot</u> 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 October 2012

| **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 | 1.0 | 4.4 | 9.8 | 9.1 | 1.0 | 8.3 | 8.1 |
| Overseas Equities | -0.4 | 1.9 | 9.4 | 8.9 | 3.0 | 8.3 | 7.4 |
| US Equities | -1.5 | 0.2 | **15.4** | **14.0** | 5.8 | 6.9 | 8.7 |
| Europe ex UK Equities | **2.0** | **7.4** | 5.8 | 2.2 | -1.7 | 8.8 | 8.2 |
| Japan Equities | **-1.7** | **-3.0** | **-3.1** | **0.6** | -1.6 | 4.0 | **0.7** |
| Pacific ex Japan Equities | 0.8 | 3.5 | 7.4 | 8.8 | 3.3 | 14.7 | 8.5 |
| Emerging Markets | -0.3 | 2.2 | 3.2 | 6.5 | 1.9 | **16.2** | 8.6 |
| UK Long-dated Gilts | -0.9 | -2.7 | 9.0 | 10.6 | 9.6 | 6.8 | **8.9** |
| UK Long-dated Corp. Bonds | 0.7 | 1.3 | 13.8 | 10.7 | 8.3 | 6.6 | - |
| UK Over 5 Yrs Index-Linked Gilts | 0.5 | -2.8 | 5.7 | 8.5 | 8.2 | 7.4 | 7.5 |
| High Yield (Global) | 1.5 | 2.5 | 14.2 | 12.7 | **14.8** | 11.2 | - |
| Overseas Bonds | -0.4 | -1.7 | 2.3 | 5.3 | 12.2 | 6.6 | 6.2 |
| Property * | 0.2 | 0.6 | 3.5 | 11.3 | **-1.8** | 5.9 | 8.5 |
| Cash | 0.0 | 0.2 | 0.9 | 0.8 | 2.0 | **3.4** | 4.8 |
| | | | | | | | |
| Commodities £-converted | -3.8 | -2.2 | -1.3 | 3.9 | -3.1 | 3.2 | 3.4 |
| | | | | | | | |
| Hedge Funds original $ basis * | 1.3 | 3.1 | 5.8 | 4.0 | 1.5 | 6.8 | 10.2 |
| Illustrative £-converted version * | -0.4 | 0.1 | 2.0 | 3.6 | 6.4 | 6.5 | 10.7 |
| | | | | | | | |
| Euro relative to Sterling | 1.0 | 2.3 | -6.9 | -3.5 | 2.9 | 2.4 | - |
| US $ relative to Sterling | 0.2 | -2.7 | 0.2 | 0.8 | 5.2 | -0.3 | -0.2 |
| Japanese Yen relative to Sterling | -2.5 | -5.0 | -2.3 | 5.0 | 13.2 | 4.1 | 2.0 |
| | | | | | | | |
| Price Inflation (RPI) * | 0.5 | 1.0 | 2.6 | 4.3 | 3.3 | 3.2 | 2.8 |
| Price Inflation (CPI) * | 0.3 | 1.0 | 2.2 | 3.5 | 3.3 | 2.6 | 2.2 |
| Price Inflation (RPIX) * | 0.5 | 1.0 | 2.6 | 4.3 | 3.9 | 3.3 | 2.9 |
| Earnings Inflation ** | -0.8 | -0.2 | 2.3 | 2.2 | 2.0 | 3.1 | 3.5 |
| | | | | | | | |
| All Share Capital Growth | 0.9 | 3.3 | 5.7 | 5.4 | -2.6 | 4.5 | 4.5 |
| Net Dividend Growth | 0.3 | 2.5 | 14.6 | 7.6 | 2.6 | 5.1 | - |
| Earnings Growth | -0.7 | -2.2 | -7.3 | 20.1 | -1.0 | 10.2 | - |

*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.*

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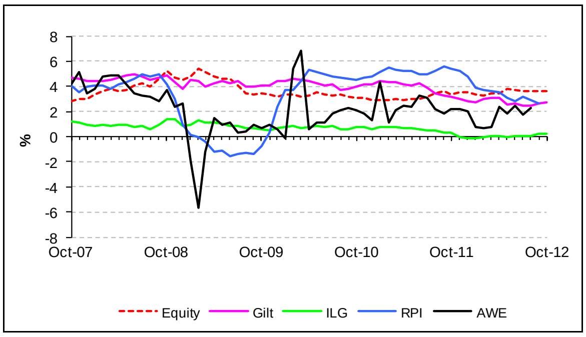
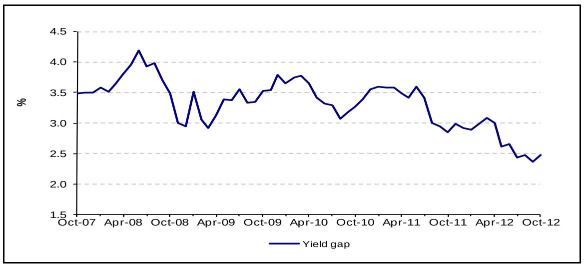
## Yields and Yield Gaps

### 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.

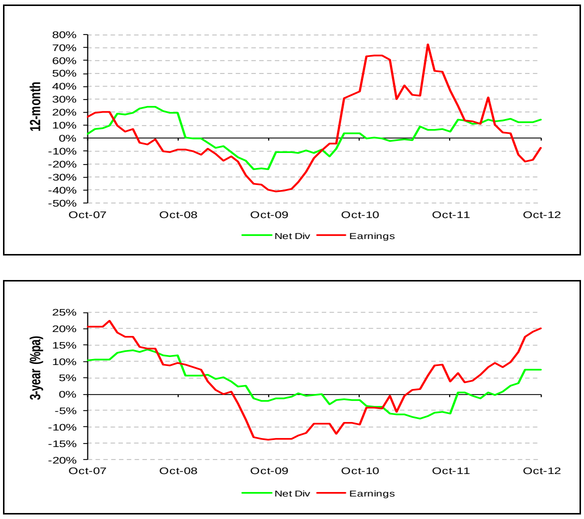



The gap gives expectations approaching 2.5% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

## 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*]

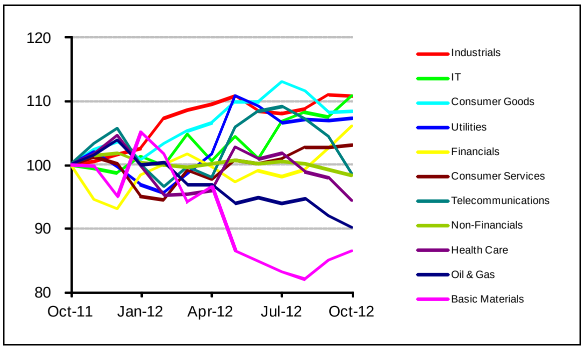
### Figure 3: Dividend & Earnings Growth




*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



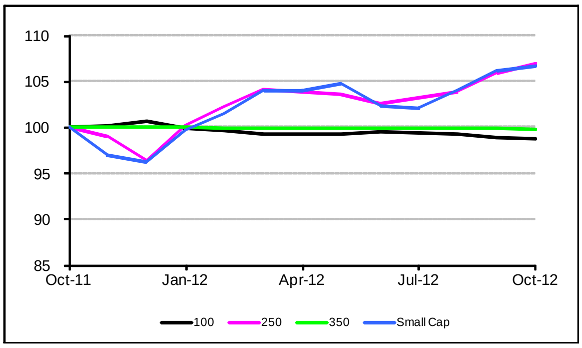

*Note: Sector labels for relative lines are in end-value order*

There was a slight rise this month in the rolling 12-month sector dispersion (up from 22% to 24%).

| (% absolute return) | 1 mth | 3 mth | 12 mth |
|---|---|---|---|
| Oil & Gas | -1.0 | 0.1 | -1.1 |
| Basic Materials | 2.7 | 8.4 | -5.1 |
| Industrials | 1.0 | 7.0 | 21.7 |
| Consumer Goods | 1.2 | 0.1 | 19.0 |
| Health Care | -2.7 | -3.2 | 3.6 |
| Consumer Services | 1.5 | 6.7 | 13.3 |
| Telecommunications | -4.7 | -5.8 | 8.1 |
| Utilities | 1.4 | 5.2 | 17.9 |
| Non-Financials | 0.1 | 2.3 | 8.1 |
| Financials | 4.5 | 12.8 | 16.5 |
| IT | 4.2 | 8.4 | 21.6 |
| All Share | 1.0 | 4.4 | 9.8 |

## 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.

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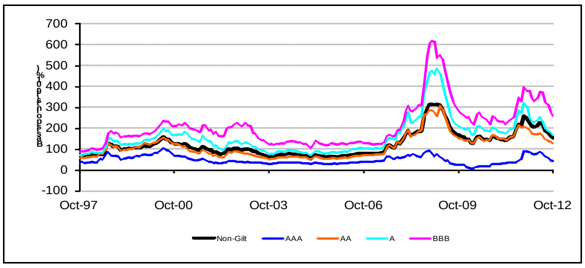
## Bond market information

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

### Figure 5: £ Non-Gilt Credit Margins




### Table 2a: Over 15 Yr <u>Corporate</u> Yields & Margins

| Month End | iBoxx Corp AA Y'ld (%) | FT 20 yr Gilt (%) | Margin (%) |
|---|---|---|---|
| May 12 | 4.18 | 2.54 | 1.64 |
| June 12 | 4.20 | 2.68 | 1.52 |
| July 12 | 3.86 | 2.47 | 1.39 |
| Aug 12 | 3.86 | 2.50 | 1.36 |
| Sep 12 | 3.98 | 2.60 | 1.38 |
| Oct 12 | **3.98** | **2.72** | **1.26** |

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

| Category | Mkt Val (£bn @ Oct 12 & 09, 06) | | | Weight (%) |
|---|---|---|---|---|
| Gilts (35) | 1,091 | 666 | 320 | 67.3 |
| Non Gilts (1,028) | 529 | 482 | 407 | 32.7 |
| AAA (169) | 139 | 150 | 152 | 8.6 |
| AA (149) | 66 | 66 | 64 | 4.1 |
| A (354) | 176 | 165 | 124 | 10.8 |
| BBB (356) | 149 | 98 | 64 | 9.2 |

| Category | Mkt Val (£bn @ Oct 12, & 09) | | W't (%) | Dur'n (yrs) |
|---|---|---|---|---|
| Gilts (35) | 1,091 | 666 | 67.3 | 9.7 |
| < 5 Yrs (10) | 305 | 201 | 18.9 | 2.9 |
| 5–15 Yrs (10) | 347 | 213 | 21.4 | 7.0 |
| > 15 Yrs (15) | 438 | 252 | 27.0 | 16.7 |
| Non Gilts (1,028) | 529 | 482 | 32.7 | 8.0 |
| < 5 Yrs (290) | 142 | 154 | 8.8 | 2.7 |
| 5–15 Yrs (449) | 217 | 192 | 13.4 | 7.2 |
| > 15 Yrs (289) | 170 | 135 | 10.5 | 13.5 |

### £ Gilt Market "main" Issuance

- £1.50bn 4¾% 2015 (2.11x, 0.30%, prev. Oct 10)
- £4.06bn 4½% 2019 (1.50x, 1.13%, May 12)
- £3.85bn 1¾% 2022 (1.87x, 1.76%, Sept 12)
- £4.25bn 3¼% 2044 (2.19x, 3.27%, new)
- £1.65bn $^1/_8$% IL 2024 (2.56x, ry -0.44%, July 12)

*Note: Issuance amounts are nominals.*

### Tables 2d, 2e: € Market Size and Maturity (Oct 12)

| Category | Mkt Val (€bn) | Weight (%) |
|---|---|---|
| Sovereigns (263) | 4,520 | 57.7 |
| Non Sovereigns | 3,311 | 42.3 |
| AAA (577) | 1,259 | 16.1 |
| AA (354) | 488 | 6.2 |
| A (774) | 910 | 11.6 |
| BBB (649) | 654 | 8.4 |

| Category | Mkt Val (€bn) | Weight (%) |
|---|---|---|
| 1 – 3 Yrs (851) | 2,212 | 28.3 |
| 3 – 5 Yrs (723) | 1,801 | 23.0 |
| 5 – 7 Yrs (381) | 985 | 12.6 |
| 7 – 10 Yrs (460) | 1,482 | 18.9 |
| 10+ Yrs (202) | 1,350 | 17.2 |

### Table 2f: Breakdown of £ Index-Linked Market

| Category (Number of issues) | Mkt Val (£bn @ Oct 12 & 09) | | W't (%) | Dur'n (yrs) |
|---|---|---|---|---|
| Gilts (21) | 332 | 209 | 92.0 | 18.3 |
| < 5 Yrs (1) | 28 | 34 | 7.6 | 3.6 |
| 5 – 15 Yrs (5) | 90 | 83 | 25.0 | 8.1 |
| > 15 Yrs (15) | 214 | 91 | 59.4 | 24.4 |
| Non Gilts (44) | 29 | 21 | 8.0 | 17.1 |

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

| Month End | US (%) | Euro (%) | Sterling (%) |
|---|---|---|---|
| May 12 | 7.16 | 9.31 | 10.63 |
| Jun 12 | 6.96 | 8.95 | 10.88 |
| Jul 12 | 6.61 | 8.53 | 10.36 |
| Aug 12 | 6.45 | 7.80 | 9.68 |
| Sep 12 | 6.29 | 7.31 | 8.94 |
| Oct 12 | **6.19** | **6.81** | **8.36** |

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