JAGGER & ASSOCIATES

Investment Update
June 2012

Investment Headlines & Comment

- Anyone for **Kilts**? Consultation has started on letting Scotland issue its own bonds from 2015/16.
- Global **bank downgrades** and an emerging UK scandal on fixing LIBOR rates.
- **UK Property** returned 0% this month, with a capital fall of 0.5% (Retail was the worst sector).

Feature Section

This month we return to the subject of Defined Contribution (aka Money Purchase) arrangements, which we last considered in our May 2002 edition of *Update*. The reason for our (belated?) return is this month's publication of guidance from the Pension Regulator on 36 key features - the core components of a DC scheme that are most likely to result in a better income for savers at retirement.

There are six principles covered by the Regulator with 36 features: 10 "essential features", 6 establishing governance, 3 on people, 8 for ongoing governance and monitoring, 4 for administration, and 5 for communication. Investment is mostly in the "essential features" section, but the whole thing is little more than you'd come up with for yourself, given a blank sheet of paper and enough willpower to think about the subject. However, it has prompted the ABI and IMA to announce that they will consider joint initiatives to build industry standards for the development of DC schemes.

On a positive note, the Regulator's (reasonable) view is that Trustees should predominantly invest scheme assets with entities regulated by the Financial Services Authority or similar regulatory authorities. Other views include that where unregulated investment options are offered, it must be "demonstrable why it was [thought] appropriate to offer those investment options". Similarly, the Trustees should understand levels of financial protection available to members and carefully consider situations where compensation is not available (for example, there are limitations within the FSCS, to which we may return). The number and risk profile of investment options offered must reflect the financial literacy of the membership (but different ranges of investment options could be offered to different membership "groups").

The Regulator requires that a default strategy is provided which "complies with DWP default fund guidance and scheme investment strategy". (The DWP issued guidance in May 2011 (DWP guidance) but this too is very much principles-based, rather than detail-specific.) The Regulator goes on to note that all costs and charges borne by members should be transparent and communicated clearly at point of selection to enable value-for-money comparisons to be made, and to assess the fairness to members of the charges (and this seems a perfectly reasonable line to take).

Within the ongoing governance section, the Regulator notes that the performance of each investment option, including the default, should be regularly assessed against stated investment objectives, and the ongoing suitability of the default strategy should be monitored. This last point is one where we think some changes have come in since our May 2002 edition. Back then, the pre-switching component in Lifestyle was usually an equity fund or a managed fund, and in many cases an index-tracking fund was the default (both on cost grounds, and to minimize the risk of manager underperformance). However, some schemes have now included Absolute Return (or Diversified Growth) alongside (or in some cases instead of) equity or managed funds – see our October 2007 edition for an introduction to Absolute Return funds. It is worth pointing out that market-tracking is not possible for Absolute Return, so some manager risk has to be accepted. Similarly, "cash+4%" may seem a useful target in 'normal' markets, but Trustees will need to consider how (or if) managers adapt this target during periods where cash is expected to be producing unusually low returns.

Within the communication section, the Regulator notes that members should be regularly informed that their level of contributions is a key factor in determining the overall size of their pension fund, and likewise regularly informed of the importance of reviewing the suitability of their investment choices. The big question, though, is will it really make any difference? How many ordinary DC scheme members really appreciate the scale of saving that is required to provide a decent pension at retirement? Ignoring means-testing, the ultimate 8% minimum "employee + employer" contribution rates specified under auto-enrolment may lull people into a false belief that 8% will be sufficient for a decent pension, but back-of-envelope suggests that will only lead to an annuity of roughly 17% of salary if paying in for 25 years, and 31% if paying in for 35 years (assuming no pension increases *and* no tax-free cash sum taken either) – paltry payouts compared with the benefits from the former gold-standard of Defined Benefit schemes.

Of course, it gets worse. Can most members of good DC schemes even *imagine* working towards having a savings pot of eight or ten times their salary, or more? Investor psychology will become increasingly important - will these DC members be willing to take *any* investment volatility, once their savings pots get anywhere near those levels, even if their retirement is still (say) 10 years away? Yet if they damp down the investment profile, then they'll face having to increase contributions … not that this has arisen yet, given DC's shorter life-history, but it's coming soon to a scheme near you.

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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 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 June 2012

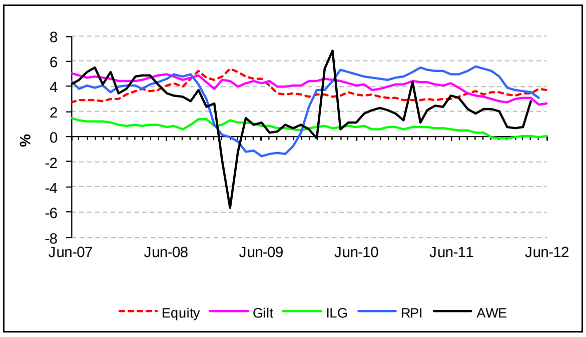
Asset Class	**1 month (%)**	**3 months (%)**	**12 months (%)**	**3 years (% p.a.)**	**5 years (% p.a.)**	**10 years (% p.a.)**	**20 years (% p.a.)**
UK Equities	5.1	-2.6	-3.1	13.8	0.4	6.1	8.0
Overseas Equities	2.9	-3.7	-4.2	13.1	3.2	6.2	8.3
US Equities	2.1	-1.0	7.8	**18.3**	5.5	5.3	8.6
Europe ex UK Equities	**6.7**	**-7.2**	**-20.2**	6.5	**-2.6**	5.5	**9.4**
Japan Equities	3.2	-5.5	-4.8	3.5	-1.6	**2.3**	**2.4**
Pacific ex Japan Equities	2.0	-4.7	-10.6	13.4	6.2	12.4	8.8
Emerging Markets	2.0	-7.0	-13.7	11.9	5.3	**14.2**	9.3
UK Long-dated Gilts	-1.4	**6.7**	**27.9**	12.4	10.8	7.4	9.1
UK Long-dated Corp. Bonds	0.1	4.2	15.5	12.3	7.5	6.3	-
UK Over 5 Yrs Index-Linked Gilts	**-2.3**	0.8	16.9	11.6	10.1	7.9	8.2
High Yield (Global)	0.6	2.3	6.7	17.7	**13.5**	10.0	-
Overseas Bonds	-2.1	3.2	5.3	7.6	**13.5**	6.7	7.4
Property *	0.0	0.5	5.4	12.2	-2.0	6.3	8.4
Cash	0.1	0.2	1.0	**0.8**	2.4	3.5	4.9
Commodities £-converted	-0.7	-10.7	-8.6	3.8	-0.7	3.2	4.1
Hedge Funds original $ basis *	-2.5	-3.1	-5.6	5.2	1.2	5.8	10.2
Illustrative £-converted version *	2.9	0.5	1.0	6.9	6.5	5.3	11.1
Euro relative to Sterling	0.7	-2.9	-10.4	-1.7	3.8	2.2	-
US $ relative to Sterling	-1.8	1.9	2.4	1.7	5.1	-0.2	1.0
Japanese Yen relative to Sterling	-3.5	5.1	3.7	8.3	14.6	3.9	3.3
Price Inflation (RPI) *	0.0	1.0	3.1	4.4	3.3	3.2	2.8
Price Inflation (CPI) *	-0.1	0.8	2.8	3.5	3.2	2.5	2.1
Price Inflation (RPIX) *	0.0	1.0	3.1	4.5	3.9	3.3	2.9
Earnings Inflation **	-9.6	-0.6	2.3	1.7	2.3	3.1	3.6
All Share Capital Growth	4.7	-3.7	-6.6	10.0	-3.2	2.5	4.4
Net Dividend Growth	1.2	3.0	15.2	2.5	2.7	4.7	-
Earnings Growth	-0.9	-5.8	3.7	9.8	0.7	9.5	-

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

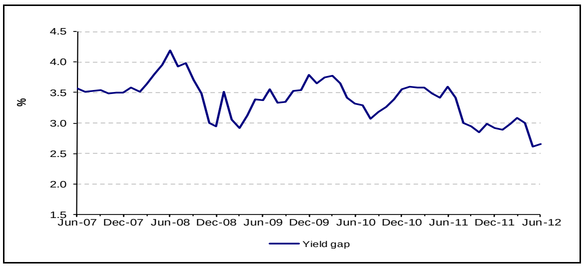
- *UK Equities (incl. dividends and earnings) – FT-A All Share.*
- *Overseas Equities (incl. regions) – blend of FT All-World / World subindices*
- *Emerging Markets from MSCI US $ based total return index (overall Index to 31 Oct 2001, Free Index from 1 Nov 2001 to take account of foreign investment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

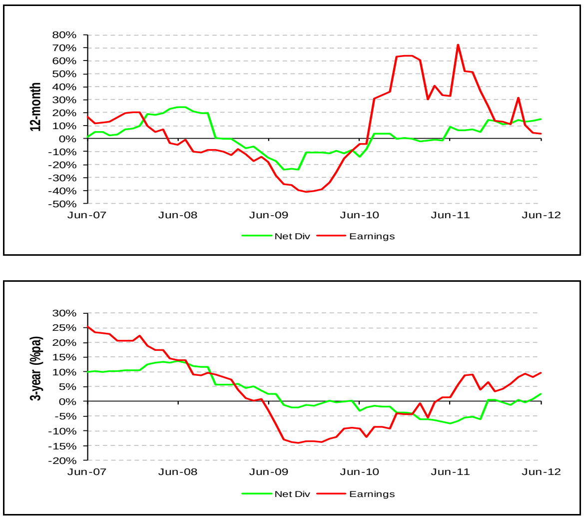


The gap gives expectations still down at just over 2.5% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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*]

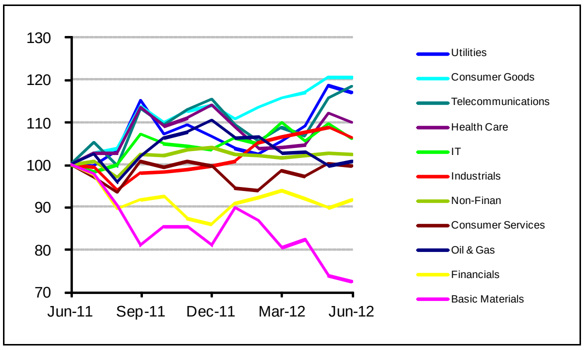
Figure 3: Dividend & Earnings Growth



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



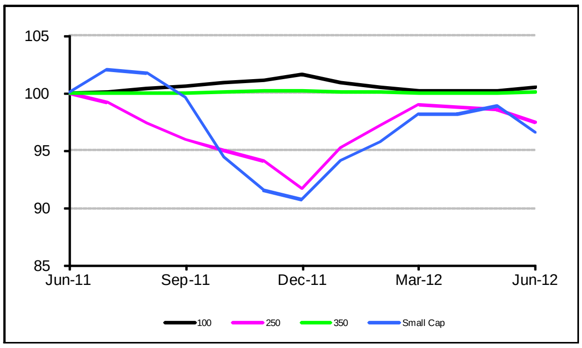
Note: Sector labels for relative lines are in end-value order

There was a slight rise this month in the rolling 12-month sector dispersion (up from 46% to 48%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	6.1	-4.6	-2.4
Basic Materials	3.0	-12.3	-29.9
Industrials	2.7	-2.8	3.1
Consumer Goods	5.1	1.5	16.9
Health Care	3.2	2.9	6.6
Consumer Services	4.4	-1.6	-3.5
Telecommunications	7.7	6.1	14.9
Utilities	3.7	8.0	13.4
Non-Finan	4.6	-2.0	-0.8
Financials	7.1	-5.1	-11.2
IT	1.7	-6.1	2.8
All Share	5.1	-2.6	-3.1

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Mid and Small Cap fell 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

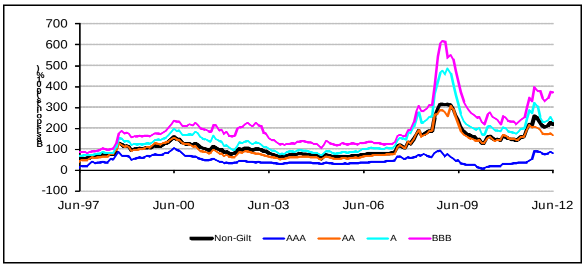


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
Jan 12	4.55	2.75	1.80
Feb 12	4.47	2.95	1.52
Mar 12	4.57	3.09	1.48
Apr 12	4.56	3.05	1.51
May 12	4.18	2.54	1.64
June 12	**4.20**	**2.68**	**1.52**

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

Category	Mkt Val (£bn @ June 12 & 09, 06)			Weight (%)
Gilts (35)	1,049	603	306	67.9
Non Gilts (1,018)	496	440	386	32.1
AAA (166)	133	145	147	8.6
AA (141)	61	62	64	3.9
A (358)	170	146	113	11.0
BBB (353)	132	84	58	8.6

Category	Mkt Val (£bn @ June 12, & 09)		W't (%)	Dur'n (yrs)
Gilts (35)	1,049	603	67.9	9.9
< 5 Yrs (9)	274	152	17.7	2.9
5–15 Yrs (11)	353	219	22.8	7.0
> 15 Yrs (15)	422	231	27.3	17.0
Non Gilts (1,018)	496	440	32.1	7.8
< 5 Yrs (282)	133	149	8.6	2.8
5–15 Yrs (457)	209	168	13.5	7.0
> 15 Yrs (279)	155	122	10.0	13.2

£ Gilt Market "main" Issuance

- £4.75bn 1% 2017 (1.28x, 0.93%, Mar 12)
- £3.57bn 1¾% 2022 (1.63x, 1.92%, new)
- £1.65bn 4% 2060 (1.81x, 3.28%, Jun 11)
- £1.37bn ILG $^1/_8$% 2029 (1.83x, r.y -0.11%, Apr 12)

Note: Issuance amounts are nominals.

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

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (259)	4,335	58.1
Non Sovereigns	3,132	41.9
AAA (579)	1,215	16.3
AA (416)	580	7.8
A (776)	890	11.9
BBB (528)	446	6.0

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (848)	2,133	28.6
3 – 5 Yrs (729)	1,740	23.3
5 – 7 Yrs (367)	933	12.5
7 – 10 Yrs (405)	1,363	18.3
10+ Yrs (209)	1,296	17.4

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ June 12 & 09)		W't (%)	Dur'n (yrs)
Gilts (19)	348	186	92.2	17.5
< 5 Yrs (2)	49	33	13.1	2.7
5 – 15 Yrs (4)	88	63	23.3	8.4
> 15 Yrs (13)	210	90	55.8	24.7
Non Gilts (47)	29	20	7.8	17.4

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

Month End	US (%)	Euro (%)	Sterling (%)
Feb 12	6.65	8.36	9.40
Mar 12	6.78	8.12	9.27
Apr 12	6.68	8.58	9.47
May 12	7.16	9.31	10.63
Jun 12	**6.96**	**8.95**	**10.88**

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