JAGGER & ASSOCIATES

Investment Update
July 2012

Investment Headlines & Comment

- The **Kay Review** wants pension funds to combat short-termism in the markets by focusing on long-term manager appointments. Laudable but impractical?
- Multiple **downgrades** lead to a net move of 70 Euro-denominated bonds from AA-rated to BBB-rated (two similar scale moves from AA to A, and A to BBB).
- "Small" money purchase pots are to follow members to new jobs, under **plans by the DWP** – but there could be a risk of repeated transaction charges though?

Feature Section

This month we continue the subject of Defined Contribution (aka Money Purchase) arrangements, to consider the question mentioned last month of investor protection. We are very grateful to guest contributor Keith Webster of law firm Osborne Clarke for this month's feature. The Pensions Regulator says trustees should be aware of the protection available for investments under defined contribution schemes. What if the sponsoring employer or insurance company goes into insolvency? The answer can be surprisingly complex.

Taking **employer insolvency** first, if the sponsoring employer of an occupational pension scheme becomes insolvent the position depends on whether benefits really are 'money purchase'. The question of what are money purchase benefits has been the subject of a recent Supreme Court decision (Osborne Clarke's summary is at Houldsworth v Bridge Trustees Ltd), which was quickly followed by a 'clarifying' amendment to legislation. This amendment (which is not yet in force) is to ensure that benefits cannot be regarded as 'money purchase' if they could become underfunded. For example, any sort of guarantee or underpin provided by the scheme, or any benefit calculation using actuarial factors, may mean the benefits are not 'money purchase'.

For true money purchase benefits, the assets held for members in the scheme will not be affected by employer insolvency and will still be available to provide pension benefits, so the Pension Protection Fund (PPF) is irrelevant to them. However, if the benefits are not true money purchase benefits, any underfunding is likely to be covered by Pension Protection Fund (PPF) compensation. For those under normal pension age, the PPF offers 90% compensation, in the form of a pension in retirement, but subject to a cap (currently £30,644.85) and with limited future increases.

The other scenario is **provider default**. If the investment provider under a DC scheme gets into financial difficulty, the position depends on the type of investment and the structure of the provider. In many cases the investments will be directly backed by actual assets. For example, a UK equity fund will hold UK equities and those equities have a value which is usually unrelated to the financial position of the provider. If these assets are held in a fund which is legally separate from any liabilities of the provider, it should still be possible to withdraw the investment without suffering a loss. If however the assets are held in the same fund as the liabilities of the provider – for example life insurance or annuity liabilities – there is a risk of the assets being used to meet those liabilities. There is also a risk of loss to the members where investments are not directly linked to assets. For example, investments which offer guaranteed returns and with-profits type investments both rely on the provider being able to meet its promises.

In these cases, trustees and members would need to look to the Financial Services Compensation Scheme (FSCS). Most DC pension arrangements are invested through long-term insurance contracts which come within the FSCS regime and, for occupational schemes, it is generally accepted that trustees could claim on behalf of all scheme members. For long-term insurance, the maximum level of compensation for claims against firms declared in default is 90% of the claim with no upper limit. This should therefore provide significant protection to most members of both occupational and contract based DC schemes. The FSCS only covers business conducted by firms authorised by the FSA. If pension schemes invest in unregulated investments, those investments are unlikely to be covered by the FSCS. However, where an FSA authorised firm has negligently advised on unregulated investments, or improperly invested in unregulated investments on behalf of a client, compensation may be available from the FSCS if the FSA authorised firm goes insolvent before paying out on any claim against it.

The FSCS has never been tested in relation to pension schemes. It is not known how it would provide the compensation. Its starting position is to look for another provider to take over all the liabilities and it may well be cheaper for the financial services industry (which funds the FSCS) to take this route. If that is not possible, compensation from the FSCS would be paid as a lump sum but it is not clear whether the member would be required to put it into another pension scheme. Certainly the compensation is unlikely to be structured as a replacement pension in the same way as PPF compensation. There is some debate as to whether the FSCS has the financial clout necessary to provide the compensation in the event of a large default. It is only funded by levies on investment providers. However, there is no evidence of it being unable to meet claims made and so trustees and members will tend to rely on its protection.

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 July 2012

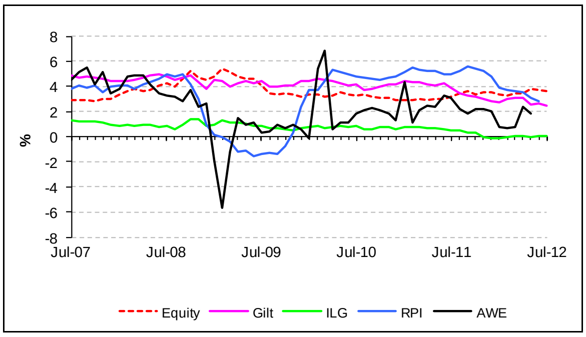
Asset Class	**1 month (%)**	**3 months (%)**	**12 months (%)**	**3 years (% p.a.)**	**5 years (% p.a.)**	**10 years (% p.a.)**	**20 years (% p.a.)**
UK Equities	1.3	-1.0	0.4	11.2	1.3	7.3	8.4
Overseas Equities	1.6	0.7	1.3	10.7	4.0	7.6	8.4
US Equities	1.5	2.7	14.2	**16.2**	6.7	6.5	9.0
Europe ex UK Equities	1.2	-0.6	**-13.3**	3.5	-1.8	7.5	9.3
Japan Equities	**-2.2**	**-3.0**	-8.1	1.6	-1.7	**3.1**	**2.4**
Pacific ex Japan Equities	3.9	0.2	-5.6	10.8	6.3	13.7	9.2
Emerging Markets	2.1	-2.4	-9.6	9.0	4.9	**15.5**	**9.6**
UK Long-dated Gilts	3.0	9.2	**25.7**	14.1	10.6	7.6	9.3
UK Long-dated Corp. Bonds	**5.7**	**10.1**	17.6	13.5	8.4	7.0	-
UK Over 5 Yrs Index-Linked Gilts	0.1	1.3	12.7	12.0	9.5	8.1	8.4
High Yield (Global)	1.7	5.1	10.1	16.1	**14.8**	10.9	-
Overseas Bonds	1.1	4.3	6.6	7.6	13.4	7.0	7.4
Property *	0.1	0.3	4.8	12.3	**-2.1**	6.2	8.4
Cash	0.1	0.2	1.0	**0.8**	2.3	3.5	4.9
Commodities £-converted	6.4	-2.9	-2.9	6.1	-0.3	4.0	4.5
Hedge Funds original $ basis *	0.3	-2.7	-4.2	5.2	1.1	6.1	10.2
Illustrative £-converted version *	-1.5	-0.9	-2.0	7.0	6.2	5.8	11.3
Euro relative to Sterling	-2.8	-3.5	-10.2	-2.8	3.1	2.3	-
US $ relative to Sterling	0.1	3.6	4.7	1.9	5.3	0.0	1.0
Japanese Yen relative to Sterling	2.2	6.0	3.5	8.8	14.6	4.3	3.5
Price Inflation (RPI) *	-0.2	0.4	2.8	4.3	3.1	3.2	2.8
Price Inflation (CPI) *	-0.4	0.1	2.4	3.3	3.1	2.5	2.1
Price Inflation (RPIX) *	-0.3	0.4	2.8	4.3	3.7	3.3	2.9
Earnings Inflation **	-0.5	-5.7	1.8	1.8	2.1	3.1	3.5
All Share Capital Growth	1.2	-1.9	-3.3	7.5	-2.3	3.6	4.8
Net Dividend Growth	0.1	2.9	12.4	3.4	2.5	4.6	-
Earnings Growth	-4.3	-9.1	-12.6	13.0	0.4	9.6	-

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

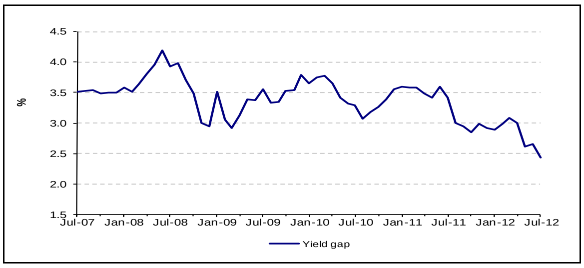
- *UK Equities (incl. dividends and earnings) – FT-A All Share.*
- *Overseas Equities (incl. regions) – blend of FT All-World / World subindices*
- *Emerging Markets from MSCI US $ based total return index (overall Index to 31 Oct 2001, Free Index from 1 Nov 2001 to take account of foreign investment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

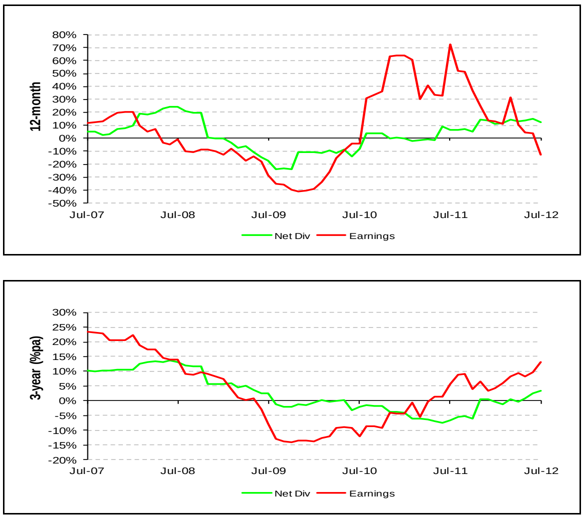


The gap gives expectations still down at just below 2.5% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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*]

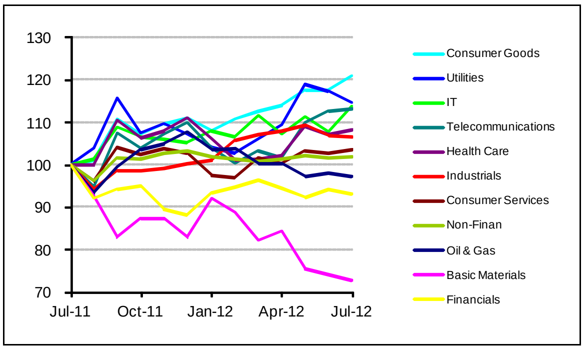
Figure 3: Dividend & Earnings Growth



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



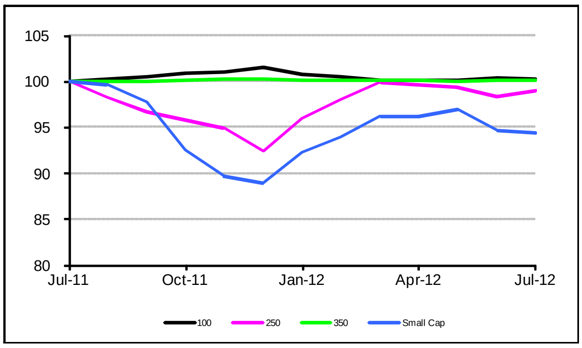
Note: Sector labels for relative lines are in end-value order

There was no change this month in the rolling 12-month sector dispersion (still at 48%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	0.4	-4.1	-2.4
Basic Materials	-0.5	-14.6	-27.0
Industrials	1.1	-2.3	7.1
Consumer Goods	4.2	4.9	21.4
Health Care	2.3	4.9	8.6
Consumer Services	2.1	2.4	4.0
Telecommunications	1.9	10.3	13.7
Utilities	-1.2	3.7	15.0
Non-Finan	1.6	-0.6	2.2
Financials	0.4	-2.5	-6.4
IT	7.1	5.1	14.3
All Share	1.3	-1.0	0.4

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Mid Cap rose but Small Cap fell slightly in relative terms this month.

FRS17 volatility indicator

Now discontinued, but available on request.

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July 2012

Bond market information

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

Figure 5: £ Non-Gilt Credit Margins

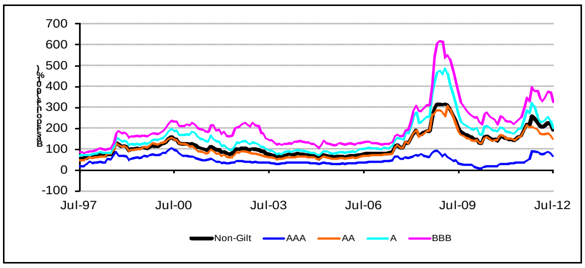

Table 2a: Over 15 Yr <u>Corporate</u> Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
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
July 12	**3.86**	**2.47**	**1.39**

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

Category	Mkt Val (£bn @ July 12 & 09, 06)			Weight (%)
Gilts (36)	1,080	620	307	67.7
Non Gilts (1,018)	516	455	392	32.3
AAA (167)	138	145	148	8.7
AA (145)	64	65	64	4.0
A (344)	171	154	115	10.7
BBB (362)	143	89	61	8.9

Category	Mkt Val (£bn @ July 12, & 09)		W't (%)	Dur'n (yrs)
Gilts (36)	1,080	620	67.7	10.0
< 5 Yrs (9)	275	163	17.3	2.8
5–15 Yrs (12)	369	226	23.1	6.9
> 15 Yrs (15)	436	231	27.3	17.1
Non Gilts (1,018)	516	455	32.3	8.0
< 5 Yrs (286)	137	153	8.6	2.8
5–15 Yrs (451)	215	179	13.5	7.1
> 15 Yrs (281)	164	124	10.3	13.4

£ Gilt Market "main" Issuance

- £4.59bn 1% 2017 (1.51x, 0.94%, Jun 12)
- £3.85bn 1¾% 2022 (2.20x, 1.72%, Jun 12)
- £1.92bn 4¾% 2030 (2.06x, 2.59%, Sept 11)
- £1.75bn 3¾% 2052 (1.67x, 3.06%, Apr 12)
- £4.00bn 1/8% IL 2044 (2.53x, ry 0.12%, new)
- £0.93bn ½% Il 2050 (2.08x, ry 0.11%, Jun 11)

Note: Issuance amounts are nominals.

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

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (258)	4,402	58.1
Non Sovereigns	3,182	41.9
AAA (561)	1,225	16.2
AA (345)	468	6.2
A (763)	899	11.9
BBB (619)	589	7.8

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (849)	2,142	28.3
3 – 5 Yrs (721)	1,749	23.1
5 – 7 Yrs (359)	944	12.5
7 – 10 Yrs (414)	1,402	18.5
10+ Yrs (203)	1,347	17.8

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ July 12 & 09)		W't (%)	Dur'n (yrs)
Gilts (20)	354	191	92.3	17.6
< 5 Yrs (2)	49	34	12.8	2.6
5 – 15 Yrs (4)	89	79	23.1	8.3
> 15 Yrs (14)	216	79	56.4	24.8
Non Gilts (47)	30	20	7.7	17.3

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

Month End	US (%)	Euro (%)	Sterling (%)
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
Jul 12	**6.61**	**8.53**	**10.36**

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