JAGGER & ASSOCIATES

Investment Update
August 2012

Investment Headlines & Comment

- Credit margins are back to levels last seen in mid 2011 before Eurozone concerns took hold.
- The Environment Agency pension scheme aims to have 25% invested in the "green economy" by 2015.
- A hedge fund returns $2bn capital (out of $8bn) to investors as it struggles to find opportunities.

Feature Section

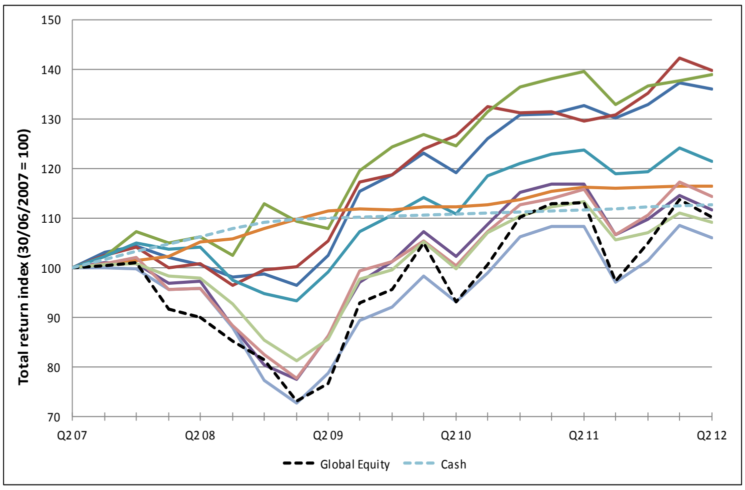
This month we return to the subject of Absolute Return funds, last considered in our October 2007 issue. During the last 5 years, these funds faced many different market conditions. Absolute Return funds combine equities, bonds, cash and alternatives (e.g. property, commodities) aiming to generate risk-controlled returns. Diversified Growth Funds are similar, but tend to make less tactical use of cash and government bonds, preferring to be fully invested in growth assets. Both fund types tend to use cash or inflation measures as benchmarks (e.g. LIBOR + 4% p.a. or RPI + 5% p.a.), however Absolute Return tends to target modest volatility with positive returns in all market conditions whereas Diversified Growth expects some negative periods.

Cash and inflation rates change significantly over time. For example, the 1 year LIBOR cash rate was 5.4% in June 2007, but 5 years later it had fallen to 1% (similarly, 1 year RPI fell from 4.4% to 2.8% over the same period), and gilt markets currently imply a cash rate in June 2017 still down at about 2%. Funds' targets are thus now significantly less than 5 years ago, although the target volatility figures (and the fee rates) may not have changed. Table 0 shows anonymised data for 9 well known providers: 5 year net of fees absolute returns, and volatility, to 30 June 2012. Market indices are also included for comparison. The funds are listed in order of return, and Figure 1 shows the evolution of the returns (including dotted lines for Equities and Cash). Funds with a below 5 year performance record are excluded.

Table 0: Fund 5 year returns and volatility

Fund	5 year returns p.a. (%)	Volatility p.a. (%)
Fund 1	6.9	7.1
Fund 2	6.8	8.3
Fund 3	6.3	7.6
Fund 4 DGF	4.0	7.5
Fund 5	3.1	1.6
Fund 6	2.7	12.7
Fund 7 DGF	2.2	12.4
Fund 8 DGF	1.7	10.6
Fund 9 DGF	1.2	13.6
Global Equity	1.9	17.4
Corp. Bonds	7.6	8.3
Cash	2.4	1.2

Figure 1: Cumulative quarterly absolute returns



Note: Global Equity is the MSCI World Index. Corporate Bonds is the iBoxx Non-Gilt Over 15 Year index. Cash is 3-month LIBOR.

As can be seen from Table 0, almost all of the funds have produced returns in excess of global equities over the 5 year period, along with much lower volatility, however few have beaten cash by much, and none have matched the (unusually high) returns on corporate bonds. A simple 60:40 Equity:Bond rebalanced portfolio would be ranked after Fund 3 on 4.5% p.a. return (but with 12.2% p.a. volatility). There is significant dispersion of returns between the funds. Figure 1 shows that much of this is due to whether funds avoided the significant equity falls in 2008 / early 2009. In Table 0 we have also labeled which ones are thought of as DGF funds. These have mostly been the worst performing funds over the period – their lack of defensive positions will have hurt them during 2008 / early 2009. (Fund 4 is labeled DGF, given how it now brands itself, however this fund could also reasonably be classed as Absolute Return.)

As a comparison to Absolute Return, over the last 5 years Hedge Funds have produced a return of 1.1% p.a. and a volatility of 10% p.a. (*source: HFR, quarterly data, US $ terms*), and they generally still have much higher fees than Absolute Return products. In response to their declining returns, over the past few years some hedge funds have downgraded their target returns in order to make them seem more achievable in future. For example, a few years ago a hedge fund may have stated its target to be Cash+8%, however as performance declined, the manager would then restate their target to be say Cash+6% in order to potentially reach this target performance (and some have reduced their fees too). If Absolute Return funds follow the same trend, will they cease to be suitable, relative to the returns required by Trustees?

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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 August 2012

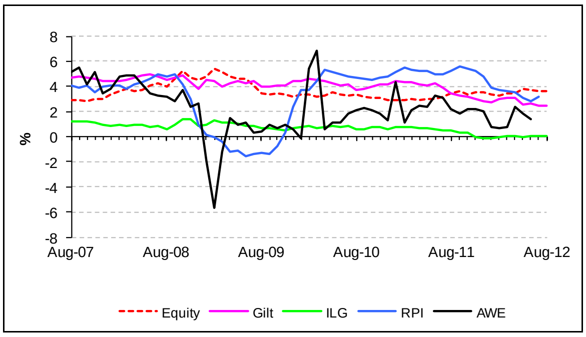
Asset Class	**1 month (%)**	**3 months (%)**	**12 months (%)**	**3 years (% p.a.)**	**5 years (% p.a.)**	**10 years (% p.a.)**	**20 years (% p.a.)**
UK Equities	2.2	8.8	10.2	9.3	1.8	7.5	8.8
Overseas Equities	0.7	5.2	9.2	9.1	4.0	7.5	8.4
US Equities	0.9	4.5	20.9	14.5	6.4	6.5	9.3
Europe ex UK Equities	**3.5**	**11.8**	0.7	1.8	-1.0	7.7	9.6
Japan Equities	**-2.1**	-1.2	-3.0	**-1.0**	-1.7	**2.8**	**1.6**
Pacific ex Japan Equities	-1.4	4.4	0.9	9.8	6.2	13.5	9.6
Emerging Markets	-1.6	2.4	**-3.1**	7.9	4.8	**15.1**	**9.9**
UK Long-dated Gilts	-0.6	1.0	**22.0**	11.3	10.1	7.1	9.3
UK Long-dated Corp. Bonds	0.6	6.4	18.9	10.8	8.4	6.5	-
UK Over 5 Yrs Index-Linked Gilts	0.5	-1.7	14.0	10.9	9.2	7.8	8.5
High Yield (Global)	0.6	2.9	14.9	**14.7**	**14.6**	10.6	-
Overseas Bonds	-0.7	**-1.8**	2.7	6.1	12.6	6.6	7.4
Property *	0.2	0.3	4.3	12.2	**-2.1**	6.1	8.4
Cash	0.1	0.2	1.0	0.8	2.2	3.5	4.8
Commodities £-converted	5.0	11.0	3.0	8.0	1.4	3.8	4.9
Hedge Funds original $ basis *	1.0	-1.3	-3.5	4.7	1.3	6.5	10.1
Illustrative £-converted version *	1.0	2.3	1.0	6.7	6.7	6.4	11.3
Euro relative to Sterling	1.0	-1.2	-10.2	-3.4	3.3	2.3	-
US $ relative to Sterling	-1.3	-3.1	2.5	0.9	4.9	-0.2	1.1
Japanese Yen relative to Sterling	-1.6	-3.0	0.1	6.7	13.5	4.0	3.4
Price Inflation (RPI) *	0.1	-0.2	3.2	4.3	3.3	3.2	2.8
Price Inflation (CPI) *	0.2	-0.3	2.6	3.4	3.2	2.6	2.1
Price Inflation (RPIX) *	0.1	-0.2	3.2	4.3	3.9	3.3	2.9
Earnings Inflation **	1.4	-8.7	1.4	1.9	2.1	3.1	3.6
All Share Capital Growth	1.5	7.7	6.1	5.7	-1.8	3.8	5.1
Net Dividend Growth	1.8	3.2	12.3	7.4	2.7	4.9	-
Earnings Growth	-3.5	-8.4	-18.2	17.6	-1.1	9.2	-

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

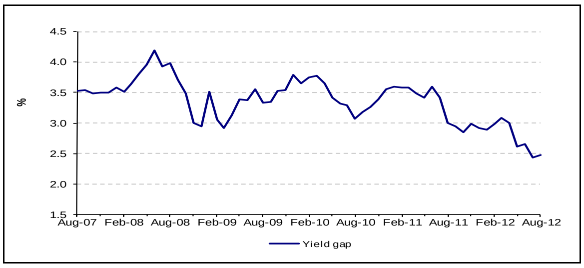
- *UK Equities (incl. dividends and earnings) – FT-A All Share.*
- *Overseas Equities (incl. regions) – blend of FT All-World / World subindices*
- *Emerging Markets from MSCI US $ based total return index (overall Index to 31 Oct 2001, Free Index from 1 Nov 2001 to take account of foreign investment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

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.

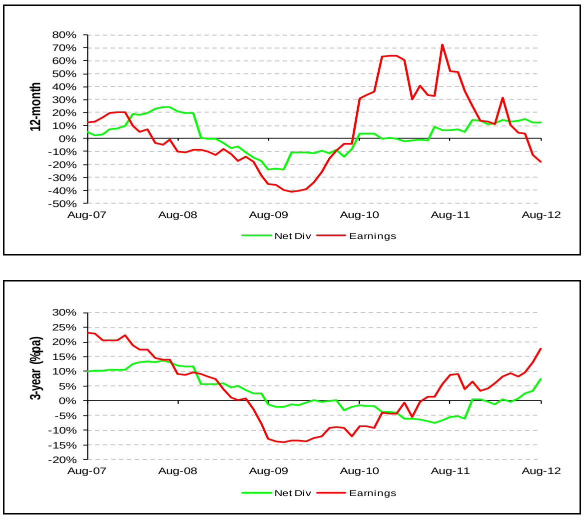


The gap gives expectations still down at just below 2.5% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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*]

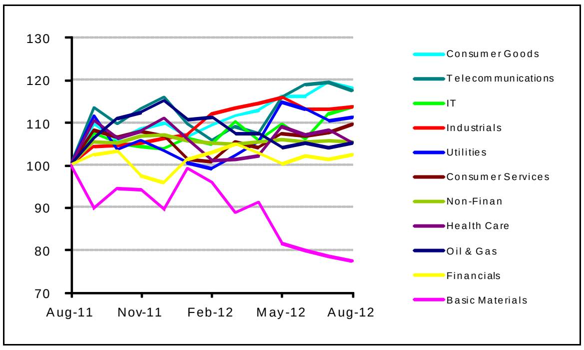
Figure 3: Dividend & Earnings Growth



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



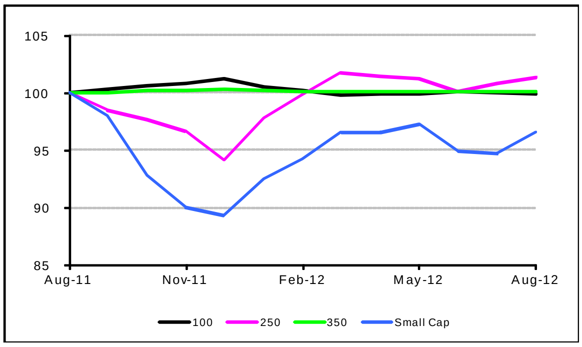
Note: Sector labels for relative lines are in end-value order

There was a fall this month in the rolling 12-month sector dispersion (down from 48% to 41%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	3.1	9.8	10.4
Basic Materials	0.7	3.2	-18.6
Industrials	2.8	6.8	19.5
Consumer Goods	0.9	10.5	24.1
Health Care	-0.6	4.8	10.5
Consumer Services	4.0	11.0	15.1
Telecommunications	0.4	10.2	23.4
Utilities	2.9	5.4	16.8
Non-Finan	1.9	8.2	10.8
Financials	3.4	11.1	7.7
IT	3.7	12.9	19.6
All Share	2.2	8.8	5.0

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

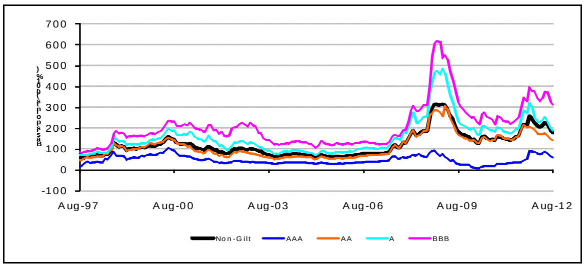


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
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
Aug 12	**3.86**	**2.50**	**1.36**

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

Category	Mkt Val (£bn @ Aug 12 & 09, 06)			Weight (%)
Gilts (36)	1,105	650	312	68.0
Non Gilts (1,014)	519	469	395	32.0
AAA (167)	139	149	149	8.6
AA (147)	65	69	64	4.0
A (342)	170	156	119	10.5
BBB (358)	145	92	59	8.9

Category	Mkt Val (£bn @ Aug 12, & 09)		W't (%)	Dur'n (yrs)
Gilts (36)	1,105	650	68.0	9.9
< 5 Yrs (9)	279	165	17.2	2.7
5–15 Yrs (12)	382	234	23.5	7.0
> 15 Yrs (15)	444	250	27.3	17.0
Non Gilts (1,014)	519	469	32.0	7.9
< 5 Yrs (283)	138	154	8.5	2.7
5–15 Yrs (450)	217	183	13.3	7.1
> 15 Yrs (281)	165	133	10.1	13.4

£ Gilt Market "main" Issuance

- £1.50bn 5% 2014 (3.42x, 0.14%, May 12)
- £4.07bn 5% 2018 (1.43x, 0.80%, Nov 11)
- £1.65bn 4½% 2034 (1.98x, 2.79%, Feb 12)
- £1.30bn 1/8% IL 2029 (1.84x, ry -0.03%, Jun 12)

Note: Issuance amounts are nominals.

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

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (258)	4,419	57.8
Non Sovereigns	3,224	42.2
AAA (566)	1,249	16.3
AA (334)	459	6.0
A (756)	890	11.7
BBB (641)	626	8.2

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (851)	2,204	28.8
3 – 5 Yrs (716)	1,728	22.6
5 – 7 Yrs (366)	976	12.8
7 – 10 Yrs (420)	1,394	18.2
10+ Yrs (202)	1,341	17.5

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Aug 12 & 09)		W't (%)	Dur'n (yrs)
Gilts (19)	335	199	91.9	18.5
< 5 Yrs (1)	28	34	7.6	3.7
5 – 15 Yrs (4)	90	81	24.5	8.2
> 15 Yrs (14)	218	84	59.8	24.6
Non Gilts (45)	30	20	8.1	17.3

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

Month End	US (%)	Euro (%)	Sterling (%)
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
Aug 12	**6.45**	**7.80**	**9.68**

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