JAGGER & ASSOCIATES

Investment Update
October 2013

Investment Headlines & Comment

- **Invesco Perpetual** are to lose Neil Woodford, much admired in retail areas, with the fund's (volatile) 10 year record 3% p.a. ahead of index.
- Asset–acquiring **Aberdeen** have confirmed they are in advanced talks to acquire the investment division of **Scottish Widows**.
- Up to 90,000 employers' DC schemes could exceed a possible **charge cap**, according to impact assessment (see below for more).

Feature Section

This month we welcome a guest contributor, Richard Leigh of TLT Solicitors, who considers how investment intermediaries are now coming under the spotlight.

The world of pensions investment is coming under increasing scrutiny. Two recent developments have put the spotlight on investment intermediaries. Firstly, the Department for Work and Pensions has published a consultation paper proposing a cap of between 0.75% and 1% a year on pension charges for auto-enrolment pension schemes. [***J&A:*** *This covers administration and investment, and it is not likely to be a problem for schemes based on index-tracking investments, but it could exclude the use of some high-target actively-managed funds.*] Consultation closes on 28 November. While auto-enrolment schemes currently represent only a small minority of all pension funds under investment, this is set to change over time. The Government expects that auto-enrolment will result in six to nine million people newly saving or saving more, generating an extra £11bn a year in pension saving, all of which will be managed by institutional investment vehicles. Thus the issue of charges is a hot one.

The second recent development is the launch by the Law Commission (the body responsible for proposing law reforms to Parliament) of a consultation paper, "*Fiduciary Duties of Investment Intermediaries*". The consultation, which closes on 22 January, arises out of the Kay Review, published in July 2012. This was highly critical of the way the UK equity market works, blaming it for promoting short-termism, and highlighting a lack of involvement by institutional shareholders in the governance of their companies. The paper is asking for views on a number of questions, but one central issue it raises is whether non-excludable fiduciary standards should apply to all relationships in the investment chain which involve discretion over the investments of others or advice on investment decisions. This was a recommendation of the Kay Review. [***J&A:*** *It is going to make a big difference whether this is limited to investment decisions on individual stocks, or on pooled funds, or as an attempt to encompass any form of investment advice.*]

At present the law on fiduciary duties is extremely flexible but also inherently uncertain. Generally, duties are to be inferred from the contract between the parties, so that (for example) a contract between two sophisticated parties stating that a sale is made on an "execution only" basis will exclude any duty on the seller to act in the interests of the buyer [**J&A:** *and there is not necessarily advice being given to either party*]. In its response to Kay the Government stated that all participants in the equity investment chain "should act in the best long-term interests of their clients or beneficiaries" [***J&A*****:** *but we suspect no definition exists of what these best long-term interests are*], and that this principle should be "independent of the classification of the client" and "should not be contractually overridden". It says that "this means ensuring that the direct and indirect costs of services provided are reasonable and disclosed".

Interestingly, the Law Commission provisionally comes down against making any statutory changes to the law on fiduciary duties in general, but does not rule out piecemeal reform where there is a lack of clarity. It seems to be open to the possibility that there should be a fiduciary duty where an investment manager is given a discretion – which of course is the default position for pension scheme trustees who need to avoid having to make day-to-day investment decisions themselves. [***J&A*****:** *See our June 2010 edition of Update for a discussion on that subject.*]

However, the Law Commission seems to prefer tackling the issue of intermediary accountability via the regulatory route. In particular, it is inviting views on whether the private retail customer's existing rights to sue for breach of statutory duty under section 138D of the Financial Services and Markets Act 2000 should be extended to business customers, and extended to cover any breach of the FCA's Principles of Business. This is a change that could have far-reaching consequences for the institutional market. [***J&A*****:** *Presumably they would attempt to extend this to cover advisory firms regulated by Designated Professional Bodies such as the Institute and Faculty of Actuaries. Does this differ from clients already being able to sue for professional negligence, and what if there is a breach but no loss?*]

Other questions the Law Commission poses include whether there is a need to review (a) the regulation of investment consultants [***J&A*****:** *acting as fiduciary managers, or on implementation, or in general provision of strategy advice?*]; (b) the law of intermediated shareholdings (i.e. affecting custodians), and (c) the regulation of stock lending by custodians. All in all, it seems that no-one in the investment chain can expect to remain immune to the increasing tide of regulation which is washing over others in the pensions industry. The message to take away is "watch this space".

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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 2013

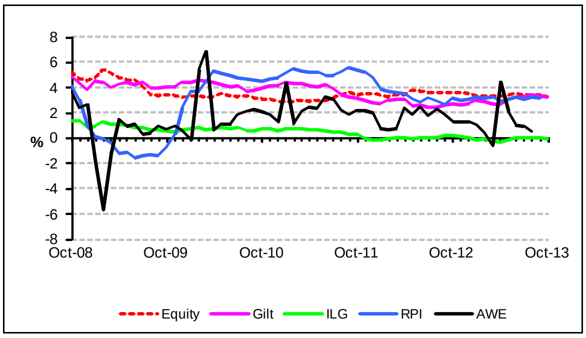
Asset Class	1 month (%)	3 months (%)	12 months (%)	3 years (% p.a.)	5 years (% p.a.)	10 years (% p.a.)	20 years (% p.a.)
UK Equities	4.3	3.1	22.8	10.7	14.5	9.1	7.8
Overseas Equities	4.9	1.1	24.6	10.7	14.4	9.0	7.0
US Equities	5.3	-1.0	28.0	**16.4**	15.5	8.4	**8.6**
Europe ex UK Equities	5.6	**5.0**	31.5	8.2	12.8	10.0	**8.6**
Japan Equities	0.9	0.3	**34.6**	8.4	8.8	4.9	**0.2**
Pacific ex Japan Equities	5.5	3.9	11.9	4.6	18.8	13.2	6.6
Emerging Markets	**5.7**	3.6	7.2	0.5	15.9	**13.4**	7.0
UK Long-dated Gilts	1.1	1.5	-2.6	8.0	8.4	6.6	7.5
UK Long-dated Corp. Bonds	2.5	3.3	3.2	8.3	11.4	6.4	-
UK Over 5 Yrs Index-Linked Gilts	1.8	2.0	8.0	9.6	9.7	7.7	7.2
High Yield (Global)	3.3	-2.2	10.3	8.9	**19.0**	9.8	-
Overseas Bonds	1.8	**-3.6**	**-3.4**	**0.4**	5.0	5.7	5.2
Property *	1.2	2.9	6.5	6.2	3.5	5.6	8.4
Cash	**0.0**	0.1	0.5	0.8	**1.0**	**3.1**	4.4
Commodities £-converted	-0.7	-7.1	-1.3	2.1	-2.4	2.0	3.4
Hedge Funds original $ basis *	1.7	2.3	7.1	3.9	5.0	5.9	9.0
Illustrative £-converted version *	-2.9	-4.1	6.9	3.0	7.1	6.2	8.6
Euro relative to Sterling	1.2	-3.4	5.2	-0.9	1.5	2.1	-
US $ relative to Sterling	0.7	-5.7	0.2	-0.2	0.1	0.5	-0.4
Japanese Yen relative to Sterling	0.8	-5.4	-18.3	-6.5	0.2	1.7	0.1
Sterling trade weighted	-1.2	4.3	-1.5	1.1	-1.2	-1.7	-0.2
Price Inflation (RPI) *	0.4	0.9	3.2	3.8	2.9	3.3	2.9
Price Inflation (CPI) *	0.3	0.7	2.7	3.3	2.8	2.7	2.1
Price Inflation (RPIX) *	0.4	0.9	3.2	3.8	3.5	3.3	2.9
Earnings Inflation **	-1.2	-1.7	0.5	1.7	1.5	2.8	3.4
All Share Capital Growth	4.1	2.1	18.5	6.9	10.4	5.4	4.2
Net Dividend Growth	0.1	1.2	7.4	8.9	0.4	5.6	-
Earnings Growth	-1.5	-6.3	-14.7	2.7	-2.4	6.1	5.9

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

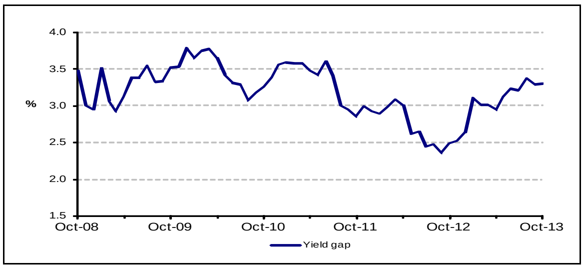
- *UK Equities (incl. dividends and earnings) – FT-A All Share.*
- *Overseas Equities (incl. regions) – blend of FT All-World / World subindices*
- *Emerging Markets from MSCI US $ based total return index (overall Index to 31 Oct 2001, Free Index from 1 Nov 2001 to take account of foreign investment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

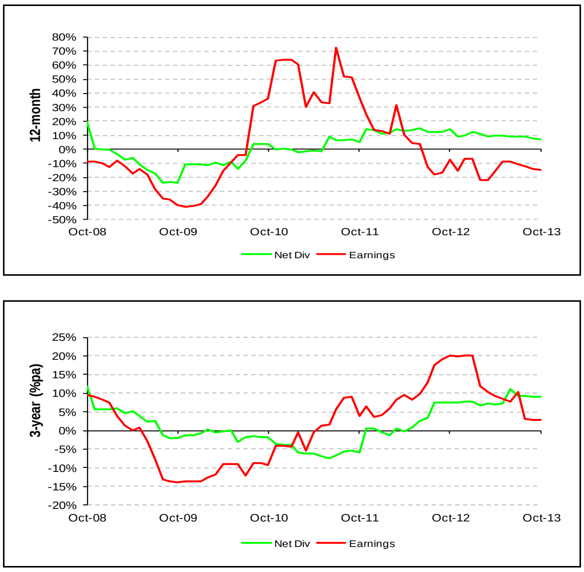


The gap gives a current expectation now clearly over 3% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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*]

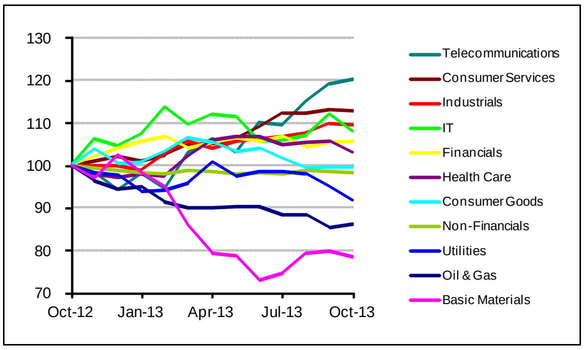
Figure 3: Dividend & Earnings Growth



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



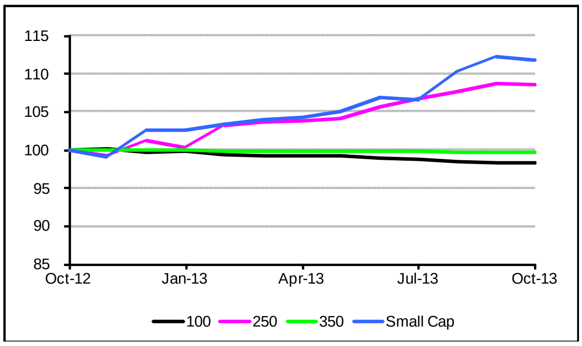
Note: Sector labels for relative lines are in end-value order

There was a rise this month in the rolling 12-month sector dispersion (from 35% to 42%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	5.3	0.5	5.8
Basic Materials	2.6	8.3	-3.6
Industrials	4.0	5.7	34.5
Consumer Goods	4.3	1.1	22.5
Health Care	1.7	1.2	26.5
Consumer Services	4.1	3.6	38.7
Telecommunications	5.4	13.4	47.9
Utilities	0.9	-4.0	12.8
Non-Financials	4.2	3.5	20.8
Financials	4.6	1.9	29.8
IT	0.4	4.9	32.6
All Share	4.3	3.1	22.8

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Mid Cap and Small Cap both fell slightly in relative terms this month.

FRS17 volatility indicator

Now discontinued, but available on request.

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Investment Update

October 2013

Bond market information

Figure 5: £ Non-Gilt Credit Margins

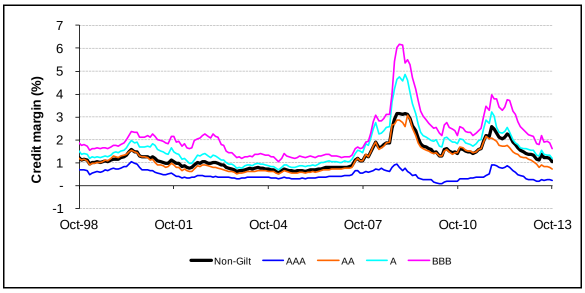

Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
May '13	4.02	2.96	1.06
Jun '13	4.47	3.30	1.17
Jul '13	4.29	3.27	1.02
Aug '13	4.35	3.42	0.93
Sep '13	4.27	3.34	0.93
Oct '13	**4.13**	**3.29**	**0.84**

Tables 2b, 2c: £ Market Size (£bn) and Maturity

Category	Mkt Val @ Oct 13 & 10, 07			Weight (%)
Gilts (37)	1,067	816	323	66.9
Non Gilts (1,030)	529	489	429	33.1
AAA (137)	106	146	155	6.6
AA (166)	86	76	66	5.4
A (352)	169	169	135	10.6
BBB (375)	168	98	69	10.5

Category	Mkt Val @ Oct 13, & 10		W't (%)	Dur'n (yrs)
Gilts (37)	1,067	816	66.9	9.6
< 5 Yrs (10)	297	255	18.6	2.9
5–15 Yrs (11)	357	281	22.4	7.0
> 15 Yrs (16)	413	279	25.9	16.7
Non Gilts (1,030)	529	489	33.1	7.9
< 5 Yrs (304)	149	141	9.3	2.7
5–15 Yrs (441)	215	210	13.5	7.2
> 15 Yrs (285)	166	139	10.4	13.4

£ Gilt Market "main" Issuance

- £5.22bn 1¼% 2018 (1.64x, 1.58%, Sep 13)
- £4.40bn 2¼% 2023 (1.84x, 2.74%, Sep 13)
- £4.50bn 3½% 20**68** (2.78x, 3.56%, Jun 13)
- £1.79bn ILG $^{1}/_{8}$% 2019 (2.77x, r.y -1.06%, Aug 13)

Note: Issuance amounts are nominals.

Tables 2d, 2e: € Market Size and Maturity (Oct 13)

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (279)	4,823	59.5
Non Sovereigns	3,284	40.5
AAA (544)	1,050	13.0
AA (387)	648	8.0
A (741)	820	10.1
BBB (745)	765	9.4

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (797)	2,180	26.9
3 – 5 Yrs (712)	1,737	21.4
5 – 7 Yrs (486)	1,282	15.8
7 – 10 Yrs (474)	1,459	18.0
10+ Yrs (227)	1,449	17.9

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Oct 13 & 10)		W't (%)	Dur'n (yrs)
Gilts (23)	381	235	92.2	18.9
< 5 Yrs (2)	45	21	10.8	3.2
5 – 15 Yrs (6)	107	97	25.8	9.2
> 15 Yrs (15)	230	117	55.6	26.5
Non Gilts (43)	32	24	7.8	17.1

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

Month End	US (%)	Euro (%)	Sterling (%)
Apr 13	5.43	4.66	5.89
May 13	5.64	4.73	6.12
Jun 13	6.26	5.36	6.64
Jul 13	5.96	5.06	6.22
Aug 13	6.16	5.09	6.32
Sep 13	6.06	5.04	6.19
Oct 13	**5.66**	**4.64**	**5.85**

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

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