



Investment Update February 2013

Investment Headlines & Comment

- The UK's AAA rating has started to go this month, for the first time since 1978 (when we were also stuck with a pile of debt).
- A novel "comic" election result in Italy led to a marked fall in their equity market, but it did not spread across the whole Eurozone.
- All Share earnings fell heavily this month due to a 37% fall for Mining earnings and a 24% fall for Banks' earnings.

Feature Section

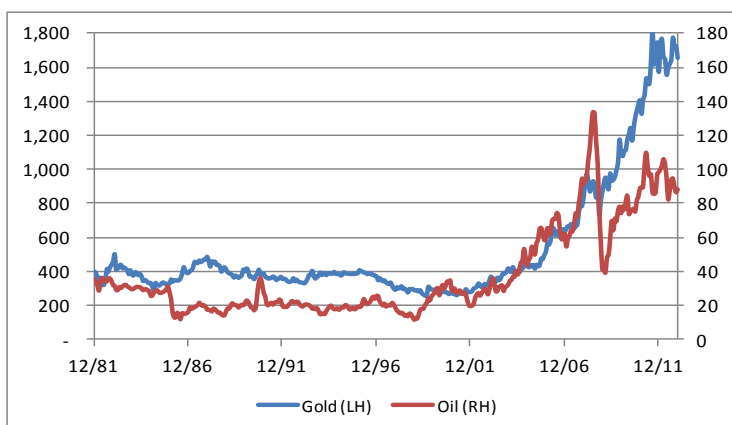
Last month the subject was Gold, and it prompted the question of how much better (or worse) Oil had been as an investment within the Commodities area. Now, Oil is a bit messier to deal with (not just literally), because its pricing has been decidedly complicated over time. The Oxford Institute for Energy Studies has produced an extensive paper "[An Anatomy of the Crude Oil Pricing System](#)" which makes for interesting (if long) reading, and we acknowledge the use of extracts from it in this article.

As the Institute's paper notes, until the late 1950s, the international oil industry outside the United States, Canada, the USSR and China was dominated by the large multinational oil companies known as the Seven Sisters or the majors. The host governments did not participate in production or pricing of crude oil and acted only as competing sellers of licences or oil concessions. In return, host governments received a stream of income through royalties and income taxes. The oil pricing system associated with the concession system until the mid 1970s was centred on the concept of a "posted" price, which was used to calculate the stream of revenues accruing to host governments. The formation of OPEC in 1960 was an attempt by member countries to prevent the decline in the posted price and thus for most of the 1960s, OPEC acted as a trade union whose main objective was to prevent the income of its member countries from declining. The year 1973 saw a dramatic shift in the balance of power towards OPEC, as it used pricing power for political purposes within the Arab-Israeli conflict. For the first time in its history, OPEC assumed a unilateral role in setting the posted price. Before then, OPEC had been only able to prevent oil companies from reducing it.

The decline in oil demand in the mid 1980s caused by a worldwide economic recession, and the growth in non-OPEC crude oil production responding to higher oil prices and taking advantage of new technologies, represented major challenges to OPEC's administered pricing system and were ultimately responsible for its demise. New discoveries in non-OPEC countries meant that significant amounts of oil began to reach the international market from outside OPEC. This increase in supply also meant an increase in the number and diversity of crude oil producers who were setting their prices in line with market conditions and hence proved to be more competitive. The adoption of the market-related pricing system by many oil exporters in 1986-1988 opened a new chapter in the history of oil price formation, with a shift to a system in which prices are set by "markets".

So, the oil price dataset we have ended up with is for the Spot Oil Price for West Texas Intermediate, for 1982 onwards as this was when it started to have a "market price" instead of the so-called "posted price". Figure 1 shows how the month-end prices for gold and oil have moved since then (note the two vertical scales, both in USD, but the left one being 10x the right one). It is clear that there have been periods where the two assets have diverged dramatically.

Figure 1: Gold and oil prices



Sources: LBMA, FRBoSL

For much of the early to mid 1990s there was no significant movement in the price for either asset, although oil was more prone to short-term price fluctuations. In the early 2000s, both assets surged, followed by an oil spike-then-crash-then rally across the time of the "credit crunch". For the last couple of years, both assets have oscillated within relatively narrow boundaries.

However, what is clear from the chart is that Gold has been a substantially better investment over the period as a whole – but the magnitude is distorted by the use of a long (31-year) timeframe on the horizontal axis. If you convert the price growth to annualized figures, you get 4.7% p.a. for Gold and 3.0% p.a. for Oil, which in turn implies that the spot oil price has (surprisingly?) lagged inflation for the period.



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 28 February 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	2.3	9.9	14.1	10.7	6.0	10.4	8.1
Overseas Equities	4.7	13.4	16.0	10.0	7.9	10.3	7.3
US Equities	5.8	13.7	19.5	13.5	11.0	8.9	8.7
Europe ex UK Equities	1.3	13.1	17.5	6.7	3.2	11.3	8.1
Japan Equities	7.2	18.4	10.5	3.7	3.4	6.3	1.0
Pacific ex Japan Equities	5.2	12.9	15.2	10.8	9.3	16.9	8.4
Emerging Markets	3.2	10.9	5.9	7.0	6.2	17.7	8.4
UK Long-dated Gilts	1.1	-3.5	2.8	11.7	8.4	6.3	8.4
UK Long-dated Corp. Bonds	1.1	-1.8	9.7	10.7	8.8	6.1	-
UK Over 5 Yrs Index-Linked Gilts	-0.4	5.1	6.5	12.4	8.6	7.8	7.8
High Yield (Global)	4.2	9.3	18.7	11.9	17.3	11.1	-
Overseas Bonds	3.5	2.1	3.8	3.6	9.8	6.1	5.7
Property *	0.4	0.7	2.4	7.8	0.4	5.7	8.5
Cash	0.0	0.1	0.7	0.8	1.7	3.3	4.6
Commodities £-converted	-0.1	4.7	-3.1	3.5	-5.1	1.0	3.2
Hedge Funds original \$ basis *	2.5	4.5	6.1	4.7	2.6	6.9	9.8
Illustrative £-converted version *	5.1	6.1	5.6	5.1	7.4	7.3	9.5
Euro relative to Sterling	0.6	6.1	2.8	-1.3	2.4	2.3	-
US \$ relative to Sterling	4.5	5.6	5.2	0.1	5.5	0.4	-0.3
Japanese Yen relative to Sterling	3.4	-5.6	-7.6	-1.1	8.1	2.9	0.9
Price Inflation (RPI) *	-0.4	0.1	3.3	4.1	3.2	3.3	2.9
Price Inflation (CPI) *	-0.5	0.2	2.7	3.4	3.4	2.7	2.2
Price Inflation (RPIX) *	-0.4	0.2	3.3	4.1	3.9	3.3	2.9
Earnings Inflation **	2.2	1.8	1.3	1.5	1.5	2.9	3.4
All Share Capital Growth	1.9	9.3	10.0	7.0	2.1	6.7	4.5
Net Dividend Growth	0.7	1.1	11.4	6.8	0.7	5.3	-
Earnings Growth	-11.6	-11.3	-21.9	11.8	-3.2	8.5	-

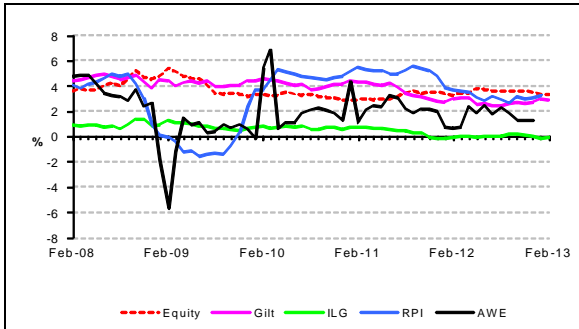
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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.

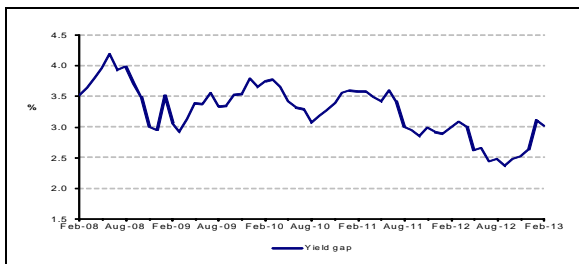


Yields and Yield Gaps

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.

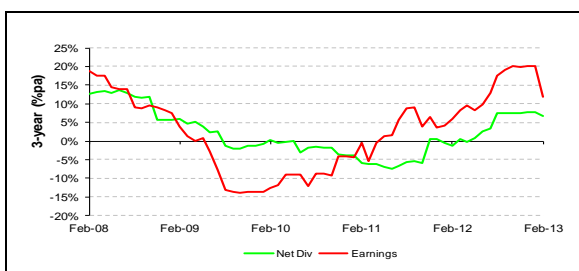
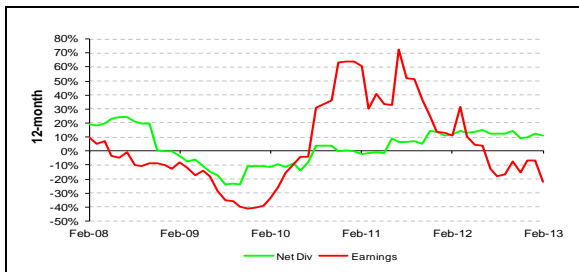


The gap gives a current expectation of about 3% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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]

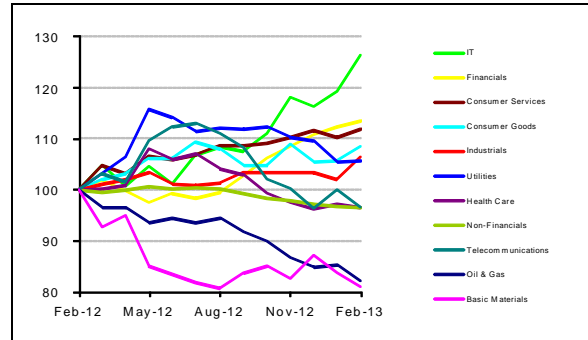
Figure 3: Dividend & Earnings Growth



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



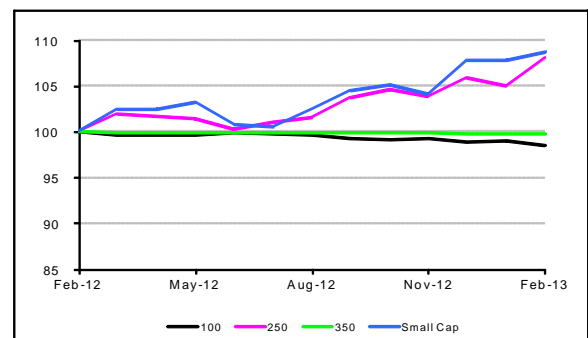
Note: Sector labels for relative lines are in end-value order

There was a rise this month in the rolling 12-month sector dispersion (up from 37% to 45%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	-1.5	4.2	-6.3
Basic Materials	-1.2	7.8	-7.7
Industrials	6.4	12.9	21.2
Consumer Goods	4.8	9.3	23.6
Health Care	1.6	9.1	10.2
Consumer Services	3.8	11.6	27.6
Telecommunications	-1.3	5.8	10.0
Utilities	2.5	5.4	20.7
Non-Financials	2.0	8.4	10.0
Financials	3.3	14.9	29.5
IT	8.3	17.6	44.0
All Share	2.3	9.9	14.1

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

Figure 5: £ Non-Gilt Credit Margins

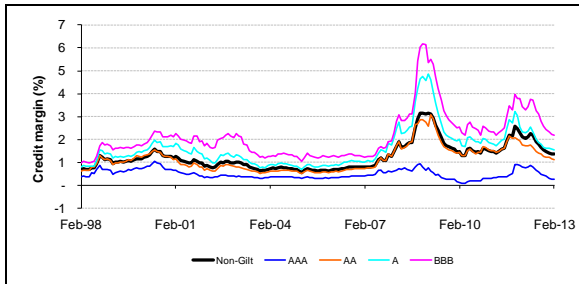


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
Sep 12	3.98	2.60	1.38
Oct 12	3.98	2.72	1.26
Nov 12	3.92	2.64	1.28
Dec 12	4.03	2.71	1.32
Jan 13	4.26	2.99	1.27
Feb 13	4.18	2.94	1.24

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

Category	Mkt Val @ Feb 13 & 10, 07			Weight (%)
	Feb 13	Feb 10	Feb 07	
Gilts (36)	1,110	704	317	67.7
Non Gilts (1,023)	529	468	412	32.3
AAA (149)	127	146	149	7.7
AA (157)	72	75	67	4.4
A (367)	180	165	125	11.0
BBB (350)	150	82	68	9.2

Category	Mkt Val @ Feb 13, & 10		W't (%)	Dur'n (yrs)
Gilts (36)	1,110	704	67.7	9.4
< 5 Yrs (10)	313	222	19.1	2.6
5-15 Yrs (11)	399	230	24.4	7.2
> 15 Yrs (15)	398	253	24.3	16.9
Non Gilts (1,023)	529	468	32.3	8.0
< 5 Yrs (287)	146	143	8.9	2.8
5-15 Yrs (444)	215	197	13.1	7.3
> 15 Yrs (292)	168	128	10.3	13.3

£ Gilt Market “main” Issuance

- o £4.40bn 1¼% 2018 (1.83x, 1.28%, new)
 - o £2.47bn 1¾% 2022 (2.25x, 2.15%, Dec 12)
 - o £1.10bn 1/8% IL 2024 (1.97x, ry -0.84%, Dec 12)
 - o £3.75bn ¼% IL 2052 (2.08x, ry 0.11%, Sept 12)
- Note: Issuance amounts are nominals.

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

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (265)	4,625	58.1
Non Sovereigns	3,342	41.9
AAA (521)	1,051	13.2
AA (395)	669	8.4
A (789)	913	11.5
BBB (689)	708	8.9

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (835)	2,147	27.0
3 – 5 Yrs (730)	1,836	23.1
5 – 7 Yrs (417)	1,092	13.7
7 – 10 Yrs (462)	1,494	18.8
10+ Yrs (215)	1,397	17.5

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Feb 13 & 10)		W't (%)	Dur'n (yrs)
Gilts (21)	360	214	92.1	18.7
< 5 Yrs (2)	46	35	11.7	3.8
5 – 15 Yrs (5)	102	85	26.2	9.8
> 15 Yrs (14)	212	93	54.3	26.2
Non Gilts (43)	31	22	7.9	17.2

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

Month End	US (%)	Euro (%)	Sterling (%)
Oct 12	6.19	6.81	8.36
Nov 12	6.13	6.36	8.02
Dec 12	5.89	* 5.17	* 6.43
Jan 13	5.76	5.27	6.30
Feb 13	5.76	5.07	6.33

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

Note: * MLX methodology changed in Dec 2012, so indices with significant “fixed-to-float” constituents now appear low-yielding, whereas specific High Yield fund yields may be somewhat different.

