JAGGER & ASSOCIATES

Investment Update
November 2014

Investment Headlines & Comment

- A remarkable month for **gilts**, with long-dated **index-linked gilts** reaching new lows for real yields.
- A very poor month for **Commodities**, with **Crude Oil** down 18%.
- **Aviva** is set to buy **Friends Life** for £5.6bn, but has seen its share price fall in the wake of the news.

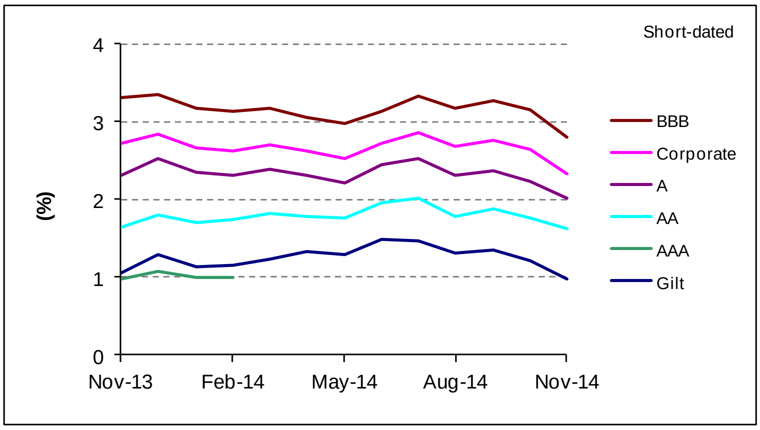
Feature Section

This month we consider some near-cash alternatives, in the wake of the UK base rate continuing to remain at the 0.5% level which has applied since March 2009. This subject could be of relevance to those institutions which have committed to invest in alternative assets (which may only draw down when the managers can place the funds, so their investors may thus have to hold cash in the meantime), and may also be relevant to those seeking a strong element of capital or downside protection. Ordinary Cash funds only yield an annual return of about 0.3% (after fees), well below base rate.

The easiest alternative approach is a “Cash Plus” liquidity fund, where the cash instruments used may have terms to maturity of (say) 18 months instead of the typical 2 months in an ordinary Cash fund. Holdings could include banks (UK and foreign) or UK Building Societies of good credit quality, above a specified minimum credit rating. They might be limited to countries with specific sovereign ratings. Lower-rated banks could sometimes be used – for example, if the sovereign government is AAA rated and also provides a guarantee. There would be limits in the fund on how much could be with each issuer. At the moment, adopting “Cash Plus” improves the annual return to about 0.8% (after fees).

The second approach is the use of a buy-and-hold portfolio of investment-grade bonds with an average duration of (say) 2-3 years, so shorter ones get dropped and longer ones get bought, but otherwise not actively managed (except perhaps for corporate restructurings, or downgrades). If restricted to true corporate bonds (hence no supranationals etc), this leads to a marked increase in yield. Figure 1 shows the recent progress in yields on different segments of the 1-5 Year corporate bond market (which can be invested in through an Exchange Traded Fund (ETF)), with short-dated gilts for comparison. As per analysis in our March 2013 edition, any adjustment down for corporate defaults is likely to be relatively small, so this appears a good diversified option relative to accepting cash returns with base rates at 0.5%.

Figure 1: 1-5 Year Monthly Bond Yields



Source: iBoxx
Note: There have been no AAA rated bonds in this market since February 2014.

It is also possible to overlay credit margins onto cash (effectively, the fund is long in its chosen areas of credit, and short in gilts) – with cash rates so low, this is likely to produce a lower return than from short-dated corporate bonds but it is achieved with less duration risk (interest rate sensitivity).

A close cousin of this construction would be a Floating Rate note (FRN), a bond with a variable coupon, equal to cash plus a quoted spread which is constant during the bond’s lifetime. Almost all FRNs pay quarterly coupons, set at the start of each quarter, as that day’s cash rate plus the spread. The downside is that these are mainly issued by banks (although in the US they are issued by mortgage corporations as well).

A further approach would be low-volatility absolute return funds, perhaps aiming for a pre-fees target of cash + 2% p.a. through holding a mix of cash and bond instruments, perhaps with some limited equity element at times. Some commentators have even advocated sub investment grade bonds as an alternative to cash. However, the cost of either of these two approaches is likely to be higher, likewise the volatility involved, and the reliance on managers will be greater.

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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 November 2014

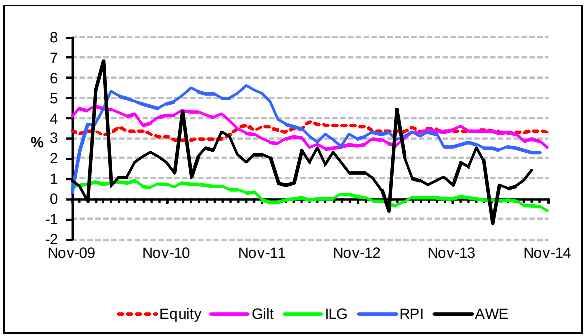
Asset Class	1 month (%)	3 months (%)	12 months (%)	3 years (% p.a.)	5 years (% p.a.)	10 years (% p.a.)	20 years (% p.a.)
UK Equities	2.9	-0.6	4.7	12.0	10.0	8.1	7.9
Overseas Equities	4.0	5.7	14.4	16.0	11.8	9.8	7.8
US Equities	4.8	**9.7**	**22.1**	**21.2**	**17.1**	10.5	8.7
Europe ex UK Equities	5.4	3.1	4.6	14.1	7.1	8.5	**10.0**
Japan Equities	2.5	4.1	3.2	11.0	7.2	5.1	**0.3**
Pacific ex Japan Equities	0.9	0.1	9.4	10.4	8.2	**12.6**	6.9
Emerging Markets	1.1	**-1.6**	6.1	5.8	4.9	12.0	6.0
UK Long-dated Gilts	**5.7**	6.0	20.6	6.4	9.1	7.3	8.6
UK Long-dated Corp. Bonds	3.8	3.0	15.4	10.3	9.3	6.7	-
UK Over 5 Yrs Index-Linked Gilts	5.6	6.6	17.0	7.4	9.5	8.2	8.2
High Yield (Global)	1.4	3.1	7.9	10.5	10.5	10.2	-
Overseas Bonds	1.6	2.1	4.1	**-0.6**	1.8	5.6	5.4
Property *	1.5	4.6	20.1	10.0	11.7	5.8	8.3
Cash	**0.0**	0.1	**0.5**	0.6	**0.7**	**2.6**	4.2
Commodities £-converted	-9.0	-16.5	-17.4	-8.8	-2.7	-2.5	2.8
Hedge Funds original $ basis *	-0.3	0.0	4.5	5.3	5.0	5.5	8.7
Illustrative £-converted version *	1.0	5.5	4.9	5.6	5.7	7.0	8.8
Euro relative to Sterling	1.7	0.4	-4.2	-2.4	-2.7	1.4	-
US $ relative to Sterling	2.2	6.1	4.6	0.1	0.9	2.0	0.0
Japanese Yen relative to Sterling	-3.5	-7.2	-9.8	-13.1	-5.3	0.6	-0.9
Sterling trade weighted	-1.3	-1.3	2.4	2.5	1.7	-1.5	0.0
Price Inflation (RPI) *	0.0	0.7	2.3	2.7	3.6	3.2	2.9
Price Inflation (CPI) *	0.1	0.5	1.3	2.0	2.8	2.7	2.1
Price Inflation (RPIX) *	0.0	0.7	2.4	2.7	3.6	3.3	2.9
Earnings Inflation **	0.5	-2.1	1.4	1.4	1.6	2.6	3.3
All Share Capital Growth	2.6	-1.3	1.3	8.2	6.3	4.4	4.4
Net Dividend Growth	0.7	0.6	0.4	5.6	6.0	4.9	-
Earnings Growth	-6.3	-11.0	-8.1	-9.0	9.0	3.8	4.9

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



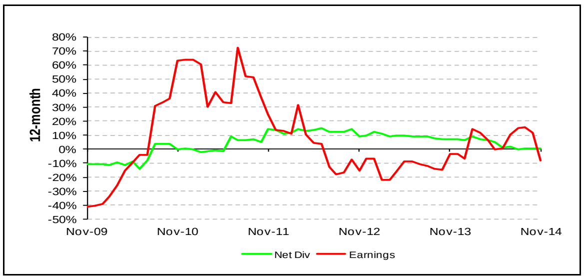
The yield gap is a measure of expected average future inflation, derived as long bond yield minus ILG yield.

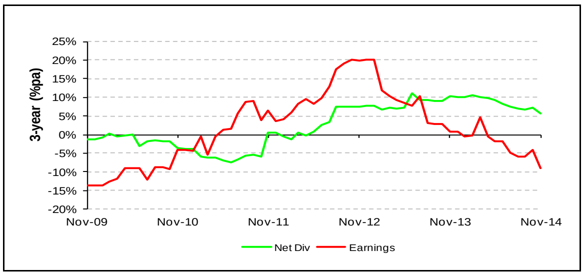
The gap gives a current expectation now around 3.2% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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

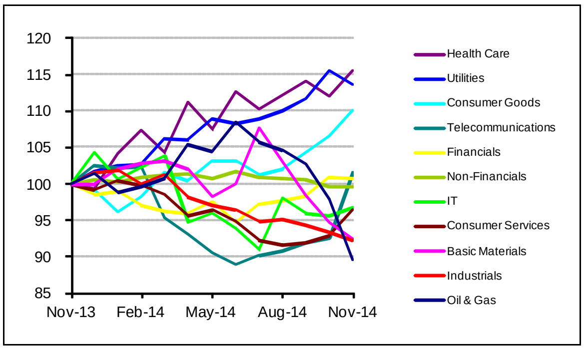




Sources for charts on this page:
Financial Times, Office for National Statistics, J&A

UK Equity Sector Returns

Figure 4a: Sectors relative to All Share



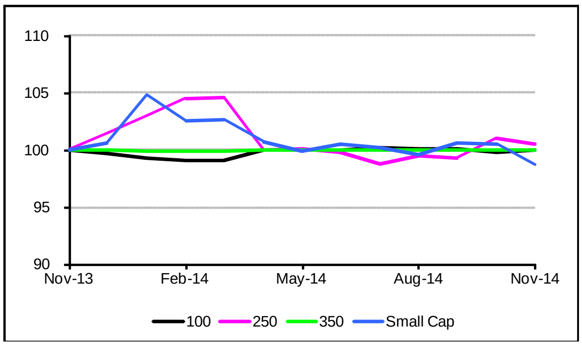
Note: Sector labels for relative lines are in end-value order

There was a rise this month in the rolling 12-month sector dispersion (from 23% to 26%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	-5.9	-15.0	-6.3
Basic Materials	0.3	-10.9	-3.3
Industrials	1.6	-3.8	-3.5
Consumer Goods	6.3	7.3	15.2
Health Care	6.2	2.3	21.0
Consumer Services	6.8	4.6	0.9
Telecommunications	13.0	11.1	6.3
Utilities	1.2	2.6	19.0
Non-Financials	3.0	-1.7	4.4
Financials	2.8	2.6	5.5
IT	4.2	-1.9	1.3
All Share	2.9	-0.6	4.7

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



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

FRS17 volatility indicator

Now discontinued, but available on request.

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Bond market information

Figure 5: £ Non-Gilt Credit Margins

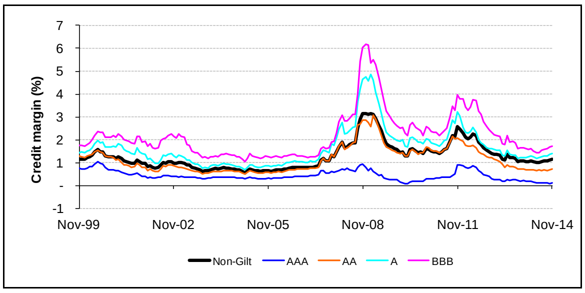

Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
Jun '14	4.12	3.31	0.81
Jul '14	4.04	3.21	0.83
Aug '14	3.70	2.86	0.84
Sep '14	3.80	2.95	0.85
Oct '14	3.76	2.85	0.91
Nov '14	**3.53**	**2.55**	**0.98**

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

Category	Mkt Val @ Nov 14 & 11, 08			Weight (%)
Gilts (39)	1,207	981	466	68.5
Non Gilts (1,051)	555	466	403	31.5
AAA (128)	105	128	153	6.0
AA (181)	94	68	71	5.3
A (357)	179	164	118	10.2
BBB (385)	176	106	58	10.0

Category	Mkt Val @ Nov 14, & 11		W't (%)	Dur'n (yrs)
Gilts (39)	1,207	981	68.5	10.4
< 5 Yrs (11)	337	277	19.1	2.9
5–15 Yrs (12)	377	313	21.4	7.3
> 15 Yrs (16)	493	392	28.0	17.9
Non Gilts (1,051)	555	466	31.5	8.1
< 5 Yrs (338)	161	123	9.1	2.6
5–15 Yrs (448)	235	198	13.4	7.7
> 15 Yrs (265)	159	145	9.0	14.3

£ Gilt Market "main" Issuance

- £3.30bn 2¾% 2024 (1.45x, 2.20%, Oct 14)
- £0.99bn ILG $^{5}/_{8}$% 2042 (2.14x, r.y -0.50%, Mar 12)
- £0.87bn ILG ½% 2050 (2.11x, r.y -0.39%, Jul 12)

Note: Issuance amounts are nominals.

Tables 2d, 2e: € Market Size and Maturity (Nov 14)

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (310)	5,449	60.4
Non Sovereigns	3,567	39.6
AAA (557)	1,057	11.7
AA (479)	825	9.2
A (773)	844	9.4
BBB (828)	841	9.3

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (803)	2,214	24.6
3 – 5 Yrs (712)	1,814	20.1
5 – 7 Yrs (633)	1,600	17.8
7 – 10 Yrs (527)	1,570	17.4
10+ Yrs (272)	1,818	20.2

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Nov 14 & 11)		W't (%)	Dur'n (yrs)
Gilts (24)	467	325	92.8	20.2
< 5 Yrs (2)	44	49	8.6	-
5 – 15 Yrs (7)	139	85	27.5	-
> 15 Yrs (15)	285	191	56.6	28.4
Non Gilts (43)	36	28	7.2	17.2

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

Month End	US (%)	Euro (%)	Sterling (%)
May '14	5.21	3.94	5.43
Jun '14	5.16	3.91	5.51
Jul '14	5.55	4.04	5.72
Aug '14	5.32	3.94	5.63
Sep '14	5.80	4.05	5.87
Oct '14	5.59	4.08	6.27
Nov '14	**5.83**	**3.91**	**6.19**

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

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