



Investment Update

August 2014

Investment Headlines & Comment

- **Barings** are set to lose their multi-asset group head and two of his senior colleagues to **Pictet**.
- Investors push the **10-year gilt yield** down to 2.4%, whilst the **30-year gilt yield** drops to 3.0%.
- Meanwhile, the German **10-year bond yield** falls to 0.9%, whilst their **30-year yield** drops to 1.7%.

Feature Section

This month we revisit the now fashionable area of infrastructure. Back in our December 2006 [edition](#), we outlined the origins of infrastructure as an asset class and highlighted potential problems (such as demand leading to overvaluation). Since then, we noted in our December 2013 [edition](#) about a pledge by a group of UK insurers to invest in infrastructure, and there has been the establishment of an [NAPF-led infrastructure fund](#). Here, Rick Alderson considers implementation.

Infrastructure Funds can be generally categorised within 4 types: a) “listed with listed underlying holdings”, b) “listed with unlisted underlying holdings”, c) “entirely unlisted”, or d) “debt”. For funds of type a), the UBS Global 50/50 Infrastructure & Utilities Index and the S&P Global Infrastructure Index are the two main indices used, covering a range of globally listed infrastructure companies (e.g. S&P’s Index uses 75 listed infrastructure companies from around the world, ranging from Chinese water utilities to UK Energy companies). Unfortunately, the high liquidity also results in equity-like volatility within the returns, both within the underlying infrastructure assets, and within the fund itself. Over the period from 2007 to date, there has been very high correlation with Global Equities (87% for the UBS Index and 93% for the S&P Index).

Funds of type b) are also listed on a stock market, however the underlying infrastructure companies in which they invest are unlisted (so either they are private companies that the fund has bought a stake in, or they were publically listed but have been bought out and delisted by the fund, or they are specific assets held within a private company wrapper). Again these funds generally invest on a global basis, however the universe of potential funds is far smaller than for the previous type a) “listed with listed” group. Type b) funds are usually fairly well-diversified, although not quite as diversified as a purely listed route, and generally have low transaction costs and reasonable annual management charges (ongoing charges ratios of c. 1%p.a. to 1.5%p.a., which may seem high versus more traditional investments, but are reasonable versus other infrastructure funds).

Given the popularity of the asset class, the share prices of most type b) funds are currently trading at premiums to their underlying net asset values (NAVs). There is a further complication with pricing, in that the calculation of the underlying NAV is subjective. Most funds will value their underlying assets at least twice yearly using a discounted cash flow analysis. This requires the use of a (project-specific) discount rate, which may or may not be sufficient to allow for the project’s level of risk. Also, if the discount rate is based on gilt rates plus a market premium, an increase in the underlying gilt rate may lead to an increase in the fund’s overall (weighted average) discount rate and a consequential decrease in the fund’s NAV.

Regular (daily) pricing of type b) funds results in *apparently* clear and unambiguous performance records at the fund level, however the deviations from the underlying NAV complicate the picture. The general level of interest in the sector may result in the risk of overpaying for the underlying investments, however many of the funds have fixed dividend targets which the managers may argue should mean that the funds cannot drastically overpay for the underlying assets. If a fund is committed to paying out a 5% p.a. dividend yield then buying assets that do not at least generate that could cause problems. It would still be possible for the fund to overpay on the dividends to keep the yield high, and then suffer a corresponding loss on the capital value, however if the portfolio weighted average discount rate (which is effectively the fund’s internal rate of return) is higher than the dividend rate, the risk of overpaying should be low, unless the actual asset sale proceeds are less than expected.

The unlisted nature of type c) funds results in a highly illiquid investment – 10 year lock-ins are not unusual, and entry is usually only possible whilst the fund is raising capital (secondary market opportunities for entry, and therefore exit, appear to be very rare). The potential universe of funds is large, but once you limit the search to those currently raising capital, and those with a UK/EU bias (for ease of monitoring) and a wide sector focus (for diversification), then the range of potential funds collapses down. Unlisted funds often have high minimum investments (e.g. £25m), and it is difficult to compare performance with other assets classes (due to the use of IRRs on invested assets, as per Private Equity). The underlying assets also suffer from the risk of overpaying because of the general level of interest in the sector, and the funds generally have fairly concentrated portfolios.

Debt financing for infrastructure has generally been provided by the banking sector, however many banks are now looking to exit some of their debt positions (due to Basel III capital adequacy requirements), which has resulted in type d), infrastructure debt funds, being launched to fill this financing gap. Debt-type investments provide investors with more security than equity-type investments, and therefore generally provide more stable returns. The income yield is also generally higher than that on equity-type investments (although the expected total return would be lower), and can even be based on a floating rate that moves in line with inflation. Infrastructure debt suffers from the same liquidity and performance monitoring issues as unlisted funds, and still forms a niche part of the market.



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 August 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	2.2	0.5	10.3	13.1	11.4	8.8	7.7
Overseas Equities	4.1	4.4	13.6	14.0	12.0	9.6	7.1
US Equities	5.8	5.8	16.7	20.0	16.5	9.6	8.2
Europe ex UK Equities	2.1	-3.9	9.6	11.4	7.7	9.3	9.2
Japan Equities	-0.5	4.9	3.0	8.5	5.0	4.5	-0.3
Pacific ex Japan Equities	2.6	7.3	13.3	7.9	10.5	13.7	6.3
Emerging Markets	4.0	8.2	12.1	4.0	7.8	13.5	5.7
UK Long-dated Gilts	6.4	8.2	14.8	9.2	8.0	7.1	8.4
UK Long-dated Corp. Bonds	5.1	6.1	14.4	10.8	9.2	6.9	-
UK Over 5 Yrs Index-Linked Gilts	5.9	5.7	11.6	9.1	9.2	7.8	7.9
High Yield (Global)	2.4	1.3	3.4	10.0	11.8	9.8	-
Overseas Bonds	2.1	1.2	-2.6	-1.1	2.4	5.5	5.3
Property *	1.6	5.3	18.5	9.0	11.9	5.8	8.2
Cash	0.0	0.1	0.5	0.7	0.7	2.7	4.2
Commodities £-converted	0.0	-4.0	-11.7	-3.0	2.3	-0.2	3.5
Hedge Funds original \$ basis *	-0.7	1.5	6.9	3.7	5.8	5.8	8.9
Illustrative £-converted version *	0.6	1.6	-4.0	2.8	5.5	6.6	8.3
Euro relative to Sterling	0.1	-2.5	-7.0	-3.6	-2.1	1.6	-
US \$ relative to Sterling	1.6	1.0	-6.9	-0.7	-0.4	0.8	-0.4
Japanese Yen relative to Sterling	0.6	-1.0	-12.0	-10.3	-2.6	1.4	-0.6
Sterling trade weighted	-0.8	1.2	7.7	3.6	1.4	-1.4	0.2
Price Inflation (RPI) *	-0.1	0.1	2.5	2.9	3.7	3.2	2.9
Price Inflation (CPI) *	-0.4	-0.2	1.6	2.3	2.9	2.7	2.1
Price Inflation (RPIX) *	-0.1	0.1	2.6	3.0	3.7	3.3	2.9
Earnings Inflation **	1.2	-7.9	0.4	1.3	1.7	2.7	3.3
All Share Capital Growth	1.5	-0.4	6.7	9.1	7.6	5.1	4.1
Net Dividend Growth	0.0	-2.5	0.0	6.9	6.2	5.1	-
Earnings Growth	-0.2	2.6	15.3	-6.0	10.5	6.0	5.5

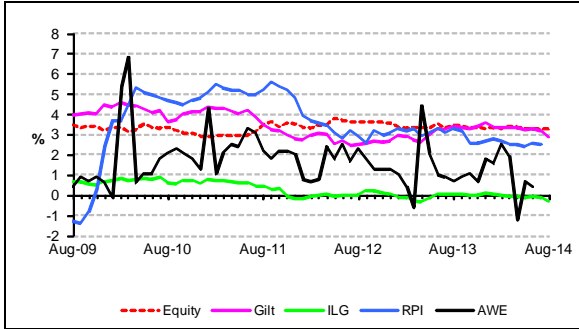
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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.

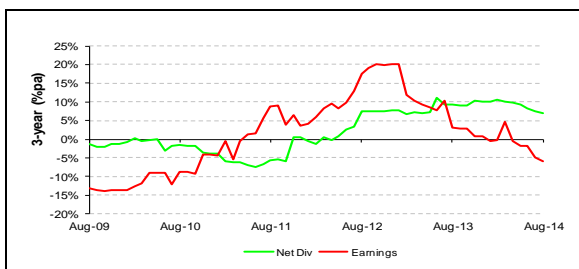
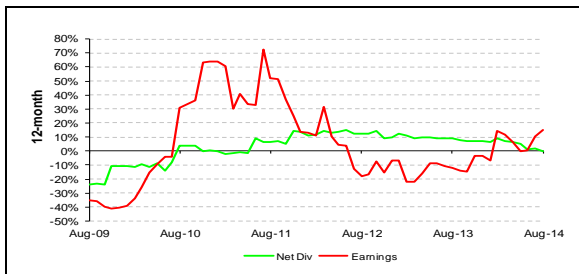


The gap gives a current expectation now around 3.2% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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]

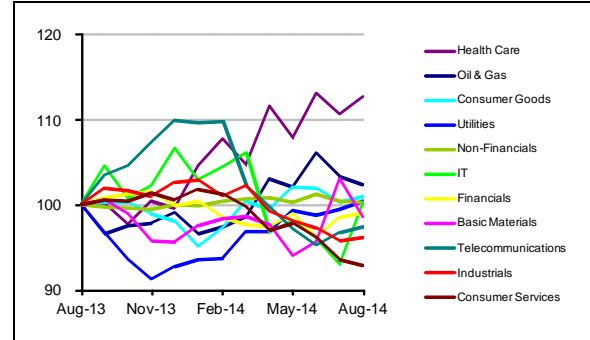
Figure 3: Dividend & Earnings Growth



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



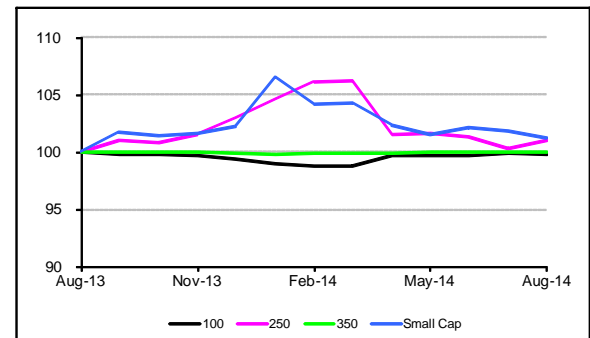
Note: Sector labels for relative lines are in end-value order

There was a slight rise this month in the rolling 12-month sector dispersion (from 18% to 20%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	1.1	0.8	12.9
Basic Materials	-2.3	5.4	8.7
Industrials	2.6	-1.4	6.1
Consumer Goods	2.8	-0.5	11.4
Health Care	4.0	5.0	24.3
Consumer Services	1.4	-4.6	2.4
Telecommunications	3.0	0.9	7.5
Utilities	3.1	1.6	10.8
Non-Financials	2.0	0.5	10.6
Financials	2.7	0.7	9.4
IT	10.1	2.7	10.6
All Share	2.2	0.5	10.3

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



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

FRS17 volatility indicator

Now discontinued, but available on request.



Bond market information

Figure 5: £ Non-Gilt Credit Margins

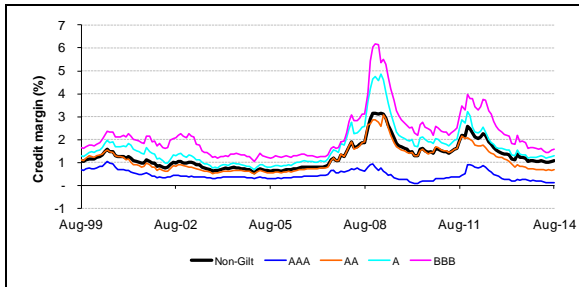


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
Mar '14	4.25	3.35	0.90
Apr '14	4.17	3.34	0.83
May '14	4.07	3.26	0.81
Jun '14	4.12	3.31	0.81
Jul '14	4.04	3.21	0.83
Aug '14	3.70	2.86	0.84

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

Category	Mkt Val @ Aug 14 & 11, 08			Weight (%)
	Aug 14	Aug 11	08	
Gilts (39)	1,181	874	369	68.1
Non Gilts (1,062)	554	469	433	31.9
AAA (132)	104	126	154	6.0
AA (182)	94	78	75	5.4
A (365)	179	163	134	10.3
BBB (383)	177	103	67	10.2

Category	Mkt Val @ Aug 14, & 11		W't (%)	Dur'n (yrs)
Gilts (39)	1,181	874	68.1	9.9
< 5 Yrs (11)	344	238	19.8	2.8
5-15 Yrs (12)	383	310	22.1	7.2
> 15 Yrs (16)	454	326	26.2	17.6
Non Gilts (1,062)	554	469	31.9	8.0
< 5 Yrs (337)	162	118	9.3	2.6
5-15 Yrs (453)	231	211	13.3	7.6
> 15 Yrs (272)	160	141	9.2	14.1

£ Gilt Market “main” Issuance

- £3.57bn 2¾% 2024 (1.69x, 2.56%, Jul 14)
 - £2.43bn 4¾% 2030 (1.56x, 2.94%, Jan 13)
 - £1.54bn ILG 1/8% 2019 (2.44x, r.y -0.87%, Jun 14)
 - £0.97bn ILG 5/8% 2040 (1.86x, r.y -0.28%, Nov 11)
- Note: Issuance amounts are nominals.*

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

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (281)	5,293	59.9
Non Sovereigns	3,547	40.1
AAA (549)	1,052	11.9
AA (469)	800	9.0
A (791)	863	9.8
BBB (811)	834	9.4

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (804)	2,171	24.6
3 – 5 Yrs (703)	1,790	20.3
5 – 7 Yrs (622)	1,508	17.1
7 – 10 Yrs (517)	1,654	18.7
10+ Yrs (255)	1,718	19.4

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Aug 14 & 11)		W't (%)	Dur'n (yrs)
Gilts (24)	437	286	92.5	19.8
< 5 Yrs (2)	44	49	9.2	-
5 – 15 Yrs (7)	132	82	28.0	-
> 15 Yrs (15)	261	155	55.2	28.1
Non Gilts (43)	35	26	7.5	17.0

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

Month End	US (%)	Euro (%)	Sterling (%)
Feb '14	5.37	4.16	5.50
Mar '14	5.40	4.11	5.45
Apr '14	5.31	4.01	5.39
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

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

