JAGGER & ASSOCIATES

Investment Update
November 2015

Investment Headlines & Comment

- **Investment grade bonds**' credit spreads narrowed a bit this month, as have some **High Yield** spreads.
- A **Bank of England** inflation report implies interest rate rises are now not due until late 2016.
- Another bad month for **Commodities** and to a lesser extent for **Emerging Markets**.

Feature Section

This month we revisit the investment aspects of the Pension Regulator's code for Defined Contribution (DC) schemes, which they updated this month. It included a timely reminder of some additional regulation which have snuck in through the back door earlier in 2015 for occupational schemes as a result of the auto-enrolment regulations.

We last looked at the Regulator's code in our June 2012 issue. In their 2012 guidance, the Regulator said the performance of each investment option, including the default, should be regularly assessed against stated investment objectives, and the ongoing suitability of the default strategy should be monitored. This has now been strengthened - an additional section has been added into the 2005 investment regulations for occupational schemes, via a completely separate set of regulations (the Occupational Pension Schemes (Charges and Governance) Regulations 2015). This set extends the requirements of the Statement of Investment Principles, potentially through having a separate Statement in respect of the default arrangement within the scheme, if it is being used for auto-enrolment purposes. The first 'challenging' wording in the regulations is that the Statement must include:

"an explanation of how the aims and objectives [of the default arrangement] are intended to ensure that assets are invested in the best interests of the group of persons consisting of relevant members and relevant beneficiaries."

Now, this might involve discussion of the standard investment risks associated with a DC scheme, which can actually work for or against a member (so ensuring their best interests could be tricky!). Strangely, these risks do not seem to have ever featured in our *Investment Update* discussions, but they can be summarized as:

- **Investment Return Risk -** the risk that a member's funds are invested in relatively low return assets for too much of their working lifetime, particularly those not protecting them from inflation.
- **Annuity Rate Risk -** close to retirement, there is the risk that a member's funds are invested in assets that do not protect against annuity rate changes (or the type of annuity to be purchased), and in some cases the potential for pension drawdown or 2014 Budget flexibility may be relevant as well.
- **Lump Sum Risk -** close to retirement, there is the risk that a member's funds are invested in assets which do not protect against capital changes, if cash is taken (or drawn down regularly to run a pot off over a short period).
- **Switching Risk -** in moving between asset types, members may suffer by moving from a temporarily depressed asset to a temporarily over-valued asset.

As a result of these four risks, a Lifestyle strategy is often used, as discussed in our May 2002 and June 2012 issues. This involves an age-related asset allocation for individual members; equity-based (or absolute return based) investment at younger ages to protect against investment return risk followed by switching into bonds (usually fixed-interest) and cash close to retirement to protect against annuity rate and lump sum risk, done steadily to reduce switching risk, the final split being the mix of pension and cash taken by a typical member.

The new-ish regulations go on to say: *"The trustees or managers must review both the default strategy and the performance of the default arrangement at least every three years; and without delay after any significant change in investment policy; or the demographic profile of relevant members. […] The trustees or managers must, in particular, review the extent to which the return on investments relating to the default arrangement (after deduction of any charges relating to those investments) is consistent with the aims and objectives of the trustees or managers in respect of the default arrangement. […] The trustees or managers must revise the statement […] after every review unless they decide that no action is needed as a result of the review."*

Now, it should not surprise any reader that over any 3-year period, the default arrangement may deviate from its expected returns – e.g. being well behind during a credit crunch, and well ahead during a QE-led rally. So, what exactly are Trustees meant to say in documenting their review to justify a conclusion that no action is required? It does not seem too much of a stretch to imagine that the move away from Global Equities to Absolute Return will be accelerated by this. And how does the demographic profile fit in if the strategy is age-based in the first place?!

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 2015

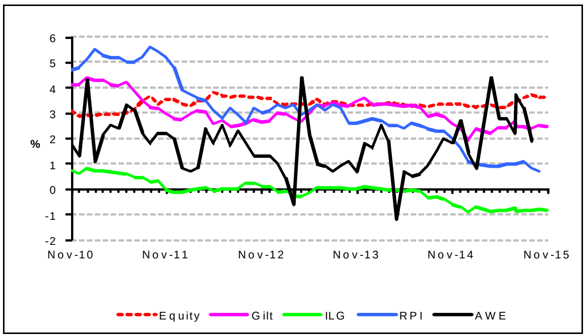
Asset Class	1 month (%)	3 months (%)	12 months (%)	3 years (% p.a.)	5 years (% p.a.)	10 years (% p.a.)	20 years (% p.a.)
UK Equities	0.6	2.4	0.6	8.1	7.7	6.1	6.9
Overseas Equities	1.9	5.6	2.4	12.6	9.5	7.6	7.0
US Equities	**2.9**	**7.9**	6.6	**18.5**	**15.1**	**9.1**	7.6
Europe ex UK Equities	0.9	2.5	0.0	9.6	6.9	6.1	8.5
Japan Equities	1.8	4.2	13.9	15.3	7.3	3.4	**1.0**
Pacific ex Japan Equities	0.1	4.8	-7.6	2.2	2.2	8.7	5.9
Emerging Markets	**-1.4**	2.1	**-13.3**	**-2.2**	**-2.1**	6.2	6.1
UK Long-dated Gilts	1.7	1.3	5.6	6.3	9.7	6.9	8.1
UK Long-dated Corp. Bonds	2.7	2.6	2.8	5.8	8.8	5.9	-
UK Over 5 Yrs Index-Linked Gilts	1.2	**-0.1**	4.0	8.0	9.7	7.7	7.8
High Yield (Global)	0.5	0.3	-0.5	4.7	6.5	8.8	-
Overseas Bonds	0.7	1.1	-0.2	-1.1	0.8	5.2	4.4
Property *	1.0	3.3	**14.7**	13.9	10.6	5.6	**8.9**
Cash	0.0	0.1	0.6	0.5	0.7	**2.2**	3.9
Commodities £-converted	-6.6	-12.7	-34.0	-19.9	-11.5	-8.2	0.0
Hedge Funds original $ basis *	1.7	-2.1	0.4	4.6	3.1	4.5	7.9
Illustrative £-converted version *	-0.3	-1.0	4.1	6.1	3.9	6.0	8.0
Euro relative to Sterling	-1.9	-3.7	-11.9	-4.7	-3.4	0.3	-
US $ relative to Sterling	2.6	2.2	4.0	2.1	0.7	1.4	0.1
Japanese Yen relative to Sterling	0.4	0.4	0.2	-10.7	-6.8	1.1	-0.9
Sterling trade weighted	0.5	1.3	7.6	3.8	2.8	-0.6	0.8
Price Inflation (RPI) *	0.0	0.3	0.7	1.9	2.8	3.0	2.8
Price Inflation (CPI) *	0.2	0.3	-0.1	1.1	2.2	2.5	2.0
Price Inflation (RPIX) *	0.0	0.4	0.8	1.9	2.9	3.2	2.8
Earnings Inflation **	-0.6	-2.2	1.9	1.4	1.6	2.3	3.2
All Share Capital Growth	0.2	1.7	-2.8	4.4	4.1	2.5	3.4
Net Dividend Growth	1.6	2.5	6.6	4.7	7.5	4.2	-
Earnings Growth	-5.8	1.7	-13.4	-8.3	-4.0	0.2	2.9

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



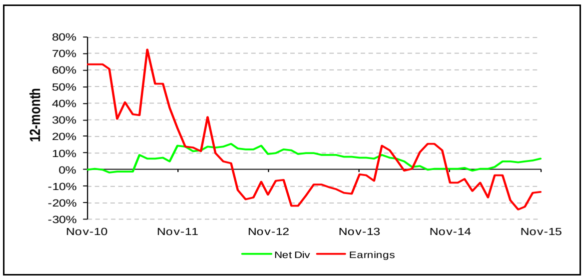
The yield gap is a measure of expected average future inflation, derived as long bond yield minus ILG yield.

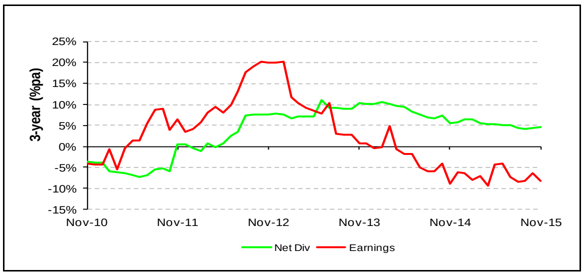
The gap gives a current expectation around 3.3% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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

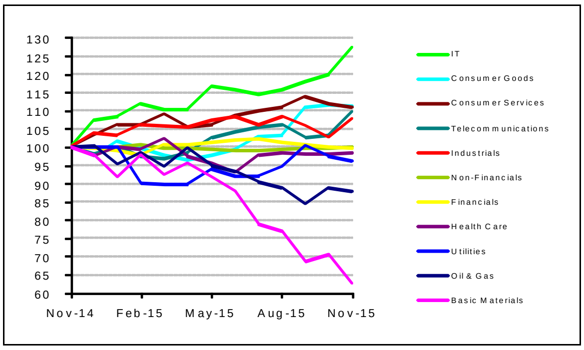




Sources for charts on this page:
Financial Times, Office for National Statistics, J&A

UK Equity Sector Returns

Figure 4a: Sectors relative to All Share



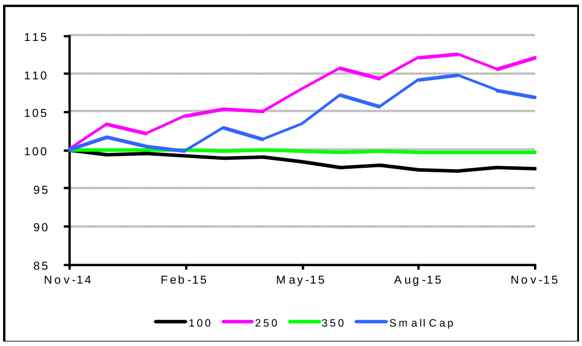
Note: Sector labels for relative lines are in end-value order

There was a clear rise this month in the rolling 12-month sector dispersion (from 53% to 65%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	-0.7	1.2	-11.5
Basic Materials	-10.6	-16.8	-36.9
Industrials	5.6	1.6	8.4
Consumer Goods	0.4	10.5	12.1
Health Care	1.0	2.5	-0.8
Consumer Services	-0.2	2.5	11.8
Telecommunications	6.7	5.8	10.5
Utilities	-0.8	4.0	-3.1
Non-Financials	0.7	2.9	0.7
Financials	0.3	1.0	0.5
IT	6.7	12.8	28.3
All Share	0.6	2.4	0.6

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Mid Cap rose but Small Cap fell in relative terms this month.

FRS17 volatility indicator

Now discontinued, but available on request.

Bond market information

Figure 5: £ Non-Gilt Credit Margins

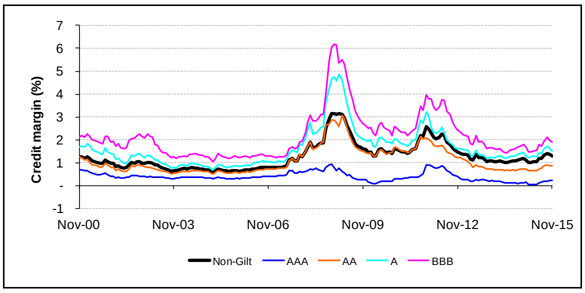


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
Jun '15	3.65	2.65	1.00
Jul '15	3.45	2.49	0.96
Aug '15	3.61	2.49	1.12
Sep '15	3.59	2.39	1.20
Oct '15	3.66	2.53	1.13
Nov '15	**3.49**	**2.47**	**1.02**

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

Category	Mkt Val @ Nov 15	& 12	09	Weight (%)
Gilts (39)	1,227	1,115	705	69.6
Non Gilts (1,034)	535	535	487	30.4
AAA (115)	97	142	152	5.5
AA (197)	97	67	66	5.5
A (334)	158	177	169	9.0
BBB (388)	183	150	97	10.4

Category	Mkt Val @ Nov 15	& 12	W't (%)	Dur'n (yrs)
Gilts (39)	1,227	1,115	69.6	10.8
< 5 Yrs (11)	350	305	19.9	3.0
5–15 Yrs (11)	335	358	19.0	7.2
> 15 Yrs (17)	541	451	30.7	18.0
Non Gilts (1,034)	535	535	30.4	7.9
< 5 Yrs (344)	157	145	8.9	2.5
5–15 Yrs (448)	231	217	13.1	7.5
> 15 Yrs (242)	147	172	8.3	14.3

£ Gilt Market "main" Issuance

- £3.35bn 2% 2025 (1.49x, 1.94%, Oct 15)
- £1.50bn 4¼% 2039 (1.59x, 2.67%, Oct 11)
- £0.77bn $^{1}/_{8}$% IL 2058 (1.79x, ry -0.76%, Aug 15)

Note: Issuance amounts are nominals.

Tables 2d, 2e: € Market Size and Maturity (Nov 15)

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (321)	5,737	61.5
Non Sovereigns	3,593	38.5
AAA (593)	994	10.7
AA (610)	989	10.6
A (767)	785	8.4
BBB (899)	825	8.8

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (779)	2,087	22.4
3 – 5 Yrs (771)	2,016	21.6
5 – 7 Yrs (717)	1,590	17.0
7 – 10 Yrs (604)	1,702	18.2
10+ Yrs (319)	1,934	20.7

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Nov 15	& 12)	W't (%)	Dur'n (yrs)
Gilts (25)	486	336	93.2	21.7
< 5 Yrs (3)	49	45	9.5	-
5 – 15 Yrs (7)	126	96	24.2	-
> 15 Yrs (15)	310	196	59.5	29.5
Non Gilts (37)	35	29	6.8	17.2

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

Month End	US (%)	Euro (%)	Sterling (%)
May '15	5.71	3.76	5.77
Jun '15	6.10	4.23	6.11
Jul '15	6.20	4.08	6.06
Aug '15	6.61	4.43	6.38
Sep '15	7.21	5.14	6.58
Oct '15	6.68	4.52	6.40
Nov '15	**7.03**	**4.37**	**6.30**

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

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