



Investment Update

June 2015

Investment Headlines & Comment

- A bad month for most markets, as fears of some form of Grexit rise. Credit spreads have increased too.
- 1/8% seems to be the lower limit for **ILG coupons**, based on this month's new 2046 issue.
- So, instead of starting a new gilt at par, investors have paid £120 now to inflation-protect their £100.

Feature Section

This month we look at the “decumulation phase” that can now arise for some individuals within defined contribution (or money purchase) arrangements. Prior to the 2014 Budget, there was a drawdown option for those with large enough pots, but now there is much more scope, particularly when it comes to tax planning. Nothing here should be construed as advice to individuals, and not tax advice either – it's just some arithmetic with a bit of statistical randomness thrown in!

We start by considering a typical 30-year old, earning £30k p.a., with total employer + employee contributions of 10% each year. Assuming a mix of equities and absolute return funds is used, and a little salary growth in real terms, the employee can plan to have (in today's money) around £300k as the accumulated pot at age 65.

(In practice, it will be quite a while until that amount is a typical pot at retirement, because not many money purchase schemes were running back in 1980. Readers may also wonder why we start with someone aged 30 – before then, house deposit and student loan payoffs are likely to be higher priorities for employees in their early working lives.)

At age 65, the investor could play safe and have a level single life annuity of around £17k p.a., or they could take £75k as tax free cash and have around £13k p.a. as the annuity. Under drawdown, the tax-free cash can be phased rather than just taken upfront, but for this modeling we assume it is still taken upfront. Even if that (after tax free cash) £225k pot earned no more return at all after age 65, the employee could instead draw down a fixed amount of £15k a year for 15 years (so admittedly, a declining amount in real terms, but then pensioner non-healthcare expenditure tends to decline in retirement).

With example state benefits of £6k per year, a £10k personal tax allowance and a 20% basic rate, the investor would have a pretty low overall effective tax rate of about 10% a year. (Note the example ignores whether the state benefits have any means testing offset that counters the benefit of having saved using employment earnings.)

If the investor retains some investment risk during the drawdown period, but spends the money that is drawn down, what is the trade-off between achieving a longer expected period until pot exhaustion, versus a higher risk of pot exhaustion by an unacceptably early age? How does that vary as the investor increases the drawdown amount? We start with the £15k example and then increase it.

A little spreadsheet work suggests that if the investor had an expected (nominal) return of 2.5% p.a. (as a proxy for current gilt yields), they would increase the expected drawdown period from 15 years to 19 years, and to create even a 1% probability of pot exhaustion by an example early age 75 requires a (by historical standards) large volatility assumption of 10% p.a.

Where it might become more of an issue is if the investor continues to pursue material investment returns whilst drawing down the £15k income stream. For example, if the investor targets an expected (nominal) return of 5% p.a. with an example volatility of 12% p.a., then there is a 0.4% probability of pot exhaustion by age 75. Increase that volatility to 15% p.a. and the probability rises to c.3% - although that is still not huge (and the expected period is c.28 years).

However, if the investor draws down at £20k a year, but still goes for our “5% return with 15% volatility” scenario, they have a 14% probability of pot exhaustion by age 75, which might be a concern (and the expected period is cut to 16 years). If the drawdown is increased to £25k a year, then the exhaustion probability jumps to 36% (with an expected period reduced to 12 years).

The tax position on unused drawdown assets is now unusually favourable relative to that on annuities (although the July Budget might change things again). In the event of death before age 75 whilst in drawdown, the investor's beneficiaries can inherit the remaining fund tax free, or continue with drawdown, with income paid tax free, or convert the drawdown fund to a lifetime annuity, with income paid tax free. If death is at or after age 75 whilst in drawdown, the same three options apply but with payments taxed as income at each beneficiary's marginal rate. The administration of this could be complicated unless the pot is split and moves to the beneficiaries' accounts.

Clearly, there are no single right answers here, but pension fund investors are going to have to consider their specific financial needs in a lot of detail in advance of entering their “decumulation phase”.



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 June 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	-5.7	-1.6	2.6	11.0	10.7	7.1	7.5
Overseas Equities	-5.1	-5.2	11.1	14.0	11.5	8.7	7.5
US Equities	-4.8	-5.4	16.6	17.3	16.2	9.5	8.0
Europe ex UK Equities	-5.6	-5.6	0.4	13.7	8.7	7.3	9.0
Japan Equities	-4.4	-2.3	19.0	13.9	8.2	5.7	1.4
Pacific ex Japan Equities	-6.8	-6.3	8.6	8.8	6.9	11.0	6.8
Emerging Markets	-5.4	-4.8	3.5	4.0	3.0	9.9	6.6
UK Long-dated Gilts	-3.2	-6.3	16.3	5.3	9.0	6.7	8.4
UK Long-dated Corp. Bonds	-4.5	-7.4	8.9	7.5	8.4	5.9	-
UK Over 5 Yrs Index-Linked Gilts	-2.8	-3.3	15.8	7.4	9.7	7.7	8.0
High Yield (Global)	-4.0	-4.3	4.4	6.6	7.3	9.2	-
Overseas Bonds	-3.4	-7.5	-0.1	-2.6	-0.1	4.7	4.5
Property *	1.2	3.6	17.6	12.1	10.2	5.8	8.7
Cash	0.0	0.1	0.6	0.6	0.7	2.4	4.0
Commodities £-converted	-3.1	2.6	-31.3	-10.8	-5.3	-5.0	2.0
Hedge Funds original \$ basis *	0.6	1.9	5.0	6.9	5.2	5.5	8.6
Illustrative £-converted version *	1.4	3.2	15.4	7.2	4.2	7.3	8.8
Euro relative to Sterling	-1.4	-2.1	-11.5	-4.3	-2.9	0.5	-
US \$ relative to Sterling	-3.0	-5.6	8.7	-0.1	-1.0	1.3	0.1
Japanese Yen relative to Sterling	-1.6	-7.5	-10.0	-13.4	-7.2	0.3	-1.8
Sterling trade weighted	1.8	4.6	5.9	4.0	2.7	-0.7	0.7
Price Inflation (RPI) *	0.2	0.7	1.0	2.2	2.9	3.0	2.8
Price Inflation (CPI) *	0.2	0.6	0.2	1.4	2.3	2.5	2.0
Price Inflation (RPIX) *	0.2	0.7	1.1	2.2	3.0	3.2	2.8
Earnings Inflation **	-9.6	1.2	2.7	2.0	2.2	2.6	3.4
All Share Capital Growth	-6.0	-2.5	-0.8	7.3	7.0	3.4	4.0
Net Dividend Growth	0.1	1.3	4.9	5.0	7.8	4.5	-
Earnings Growth	-0.2	3.5	-3.3	-4.1	4.0	3.6	4.3

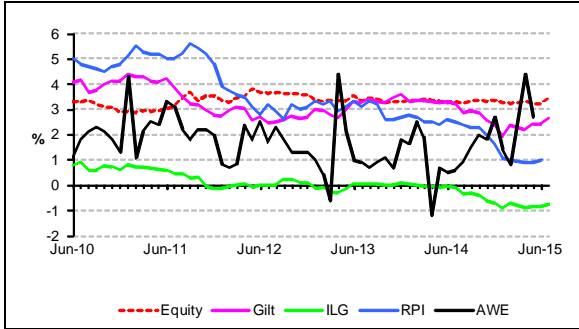
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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.

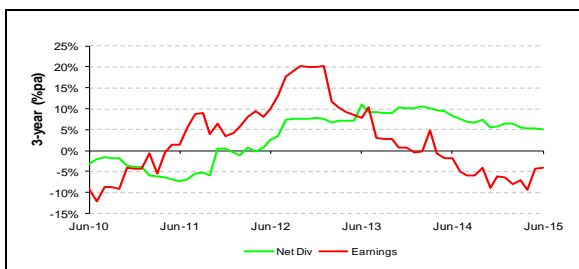
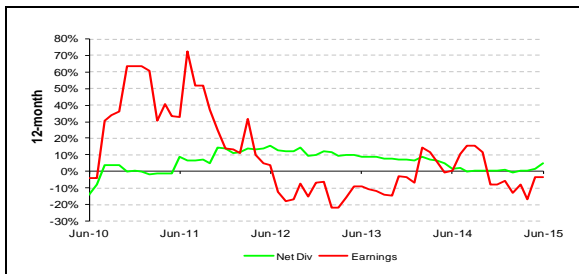


The gap gives a current expectation now clearly above 3% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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]

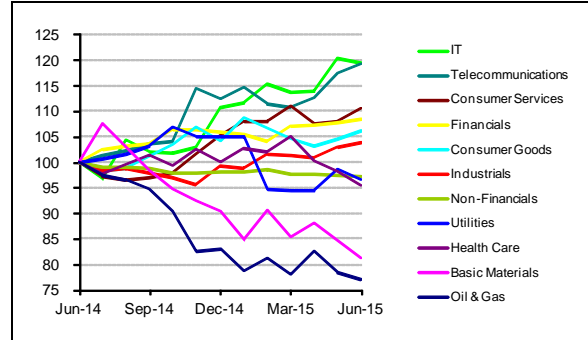
Figure 3: Dividend & Earnings Growth



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



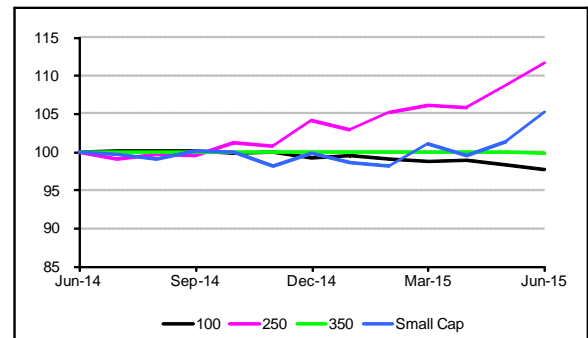
Note: Sector labels for relative lines are in end-value order

There was a rise this month in the rolling 12-month sector dispersion (from 36% to 43%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	-7.6	-2.9	-21.0
Basic Materials	-9.7	-6.4	-16.7
Industrials	-5.0	0.9	6.5
Consumer Goods	-4.2	0.0	9.0
Health Care	-8.5	-10.7	-2.1
Consumer Services	-3.5	-1.8	13.5
Telecommunications	-4.1	6.0	22.5
Utilities	-7.8	0.6	-0.9
Non-Financials	-5.9	-2.0	-0.2
Financials	-5.2	-0.4	11.3
IT	-6.4	3.3	22.6
All Share	-5.7	-1.6	2.6

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Mid and Small Cap both rose in relative terms this month.

FRS17 volatility indicator

Now discontinued, but available on request.



Bond market information

Figure 5: £ Non-Gilt Credit Margins

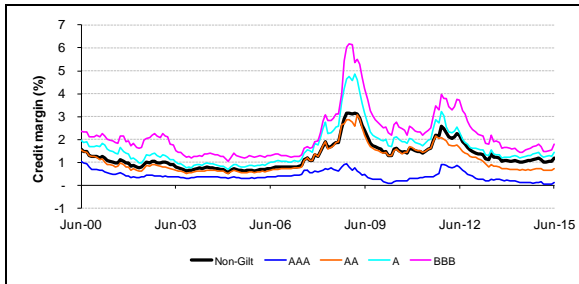


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
Jan '15	2.82	1.93	0.89
Feb '15	3.22	2.37	0.85
Mar '15	3.08	2.20	0.88
Apr '15	3.30	2.44	0.86
May '15	3.30	2.43	0.87
Jun '15	3.65	2.65	1.00

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

Category	Mkt Val @ Jun 15 & 12, 09			Weight (%)
	Jun 15	Jun 12	Jun 09	
Gilts (38)	1,190	1,049	603	69.1
Non Gilts (1,034)	531	496	440	30.9
AAA (112)	96	133	145	5.6
AA (193)	96	61	62	5.6
A (349)	165	170	146	9.6
BBB (380)	175	132	84	10.2

Category	Mkt Val @ Jun 15, & 12		W't (%)	Dur'n (yrs)
Gilts (38)	1,190	1,049	69.1	10.3
< 5 Yrs (10)	328	274	19.1	2.9
5-15 Yrs (12)	364	353	21.1	7.0
> 15 Yrs (16)	499	422	29.0	17.7
Non Gilts (1,034)	531	496	30.9	7.9
< 5 Yrs (348)	159	133	9.2	2.6
5-15 Yrs (438)	225	209	13.1	7.6
> 15 Yrs (248)	147	155	8.6	14.3

£ Gilt Market “main” Issuance

- o £3.25bn 2% 2025 (1.19x, 2.02%, Apr 15)
 - o £2.20bn 3½% 2045 (1.58x, 2.86%, Apr 15)
 - o £0.75bn 4¼% 2055 (1.22x, 2.77%, Mar 11)
 - o £0.90bn 1/8% IL 2024 (2.99x, ry -0.80%, Feb 15)
 - o £3.25bn 1/8% IL 2046 (3.54x, ry -0.58%, new)
- Note: Issuance amounts are nominals.*

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

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (320)	5,503	61.0
Non Sovereigns	3,523	39.0
AAA (537)	953	10.6
AA (563)	918	10.2
A (774)	797	8.8
BBB (908)	855	9.5

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (795)	2,120	23.5
3 – 5 Yrs (699)	1,874	20.8
5 – 7 Yrs (677)	1,550	17.2
7 – 10 Yrs (596)	1,629	18.1
10+ Yrs (335)	1,853	20.5

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Jun 15 & 12)		W't (%)	Dur'n (yrs)
Gilts (25)	494	348	93.2	20.5
< 5 Yrs (4)	76	49	14.3	-
5 – 15 Yrs (5)	106	88	20.0	-
> 15 Yrs (16)	312	210	58.9	28.4
Non Gilts (40)	36	29	6.8	17.1

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

Month End	US (%)	Euro (%)	Sterling (%)
Dec '14	6.16	4.00	6.15
Jan '15	6.07	3.81	5.83
Feb '15	5.72	3.63	5.84
Mar '15	5.90	3.77	5.86
Apr '15	5.72	3.74	5.84
May '15	5.71	3.76	5.77
Jun '15	6.10	4.23	6.11

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

