



## Investment Update June 2017

### Investment Headlines & Comment

- A weak month for **bonds**, as the prospect nears of QE unwinding and interest rates finally increasing.
- **UK Equities** fall back in response to this and uncertainty from the unexpected General Election result.
- An **FCA review** sees asset management and some investment consulting set for change.

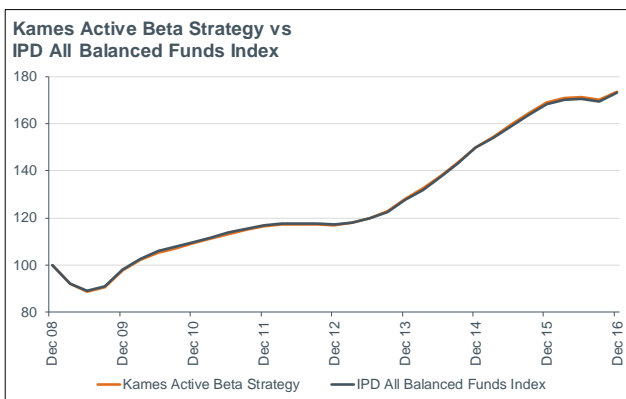
### Feature Section

This month, we welcome a guest contribution from Tony Yu of Kames Capital on an interesting development in property fund-of-funds. These emerged over a decade ago, but they have sometimes involved more volatility in their returns relative to that of the peer groups they seek to outperform. So, is there an alternative?

Most small-to-medium sized pension schemes either invest in a single balanced property fund or use multi-manager (= fund-of-funds) solutions, both of which have their drawbacks. For balanced property funds, the risks of ‘redemption runs’ have increased in recent years, making it difficult for investors to be confident in the long-term liquidity and performance prospects of any single fund. The past decade has also seen many multi-manager approaches incorporate too much leverage for schemes seeking simple exposure to UK property market returns.

One new option offered by Kames Capital is a fund which aims to track the UK commercial property funds market (**Ed.:** the lack of an index-tracker in property was one of the reasons fund-of-funds emerged). The Kames Active Beta Property Fund aims to achieve the total return (net of fees) of the IPD UK All Balanced Property Fund Index consistently and with a low tracking error. Figure 1 shows an 8-year backtest, net of fees, and allowing for transaction costs within the fund. (There is no “benefit of hindsight” here because it uses actual market trades that the manager made on other portfolios, or otherwise historic secondary market data sourced from an independent broker.)

**Figure 1: Property backtest on tracking**



Source: Kames Capital

across the UK (hence 88% of the original index by value). These represent the effective investment universe for the new fund, which will hold 12-15 balanced funds at any time, providing a diversified, representative portfolio.

The illiquid nature of property means that it is not possible to deliver a passive property market return using the same replication techniques as equity or bond tracker funds. The transaction costs of achieving ongoing replication of the market would materially impact performance, so a degree of active management is required. The key difference between the new fund and other multi-manager approaches is that it has strict risk constraints to limit tracking error and avoids exposure to leveraged and illiquid fund structures.

The secondary market is one of the ways in which Kames Capital will need to add value (to offset trading costs), enhance liquidity and manage risk. Lower transaction costs, speed of execution and the ability to access opportunistic and relative-value trades are all benefits that are available through the secondary market. Kames Capital believe this new fund is an interesting addition to the options available in the property investment market (**Ed.:** We agree). It will enable schemes to achieve far greater diversification without the additional governance time associated with appointing multiple fund managers.



**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 2017**

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	-2.5	1.4	18.1	7.4	10.6	5.4	6.5
Overseas Equities	0.0	0.5	23.4	16.3	16.0	9.4	7.7
US Equities	0.0	-0.7	21.6	<b>19.9</b>	<b>19.0</b>	12.0	7.7
Europe ex UK Equities	-1.4	<b>4.6</b>	<b>28.7</b>	11.2	15.0	5.8	8.6
Japan Equities	0.5	1.5	24.0	16.7	14.6	6.2	<b>3.1</b>
Pacific ex Japan Equities	<b>1.0</b>	1.3	27.7	14.0	11.9	9.0	7.1
Emerging Markets	0.1	2.4	27.8	11.2	8.3	6.8	7.3
UK Long-dated Gilts	<b>-3.3</b>	<b>-2.3</b>	<b>-1.8</b>	12.3	7.3	9.1	8.0
UK Long-dated Corp. Bonds	-2.0	0.4	7.3	10.5	9.0	8.3	-
UK Over 5 Yrs Index-Linked Gilts	<b>-3.2</b>	<b>-2.4</b>	7.1	13.2	9.2	9.7	8.4
High Yield (Global)	-0.3	-0.7	15.7	13.3	11.0	<b>12.2</b>	-
Overseas Bonds	-0.7	-1.2	-1.7	9.2	3.8	8.5	5.9
Property *	0.8	2.4	4.2	10.6	10.2	3.9	<b>8.8</b>
Cash	0.0	0.1	0.4	<b>0.5</b>	<b>0.5</b>	<b>1.5</b>	3.4
Commodities £-converted	-2.9	-9.0	-6.4	-17.6	-10.4	-5.7	-0.8
Hedge Funds original \$ basis *	0.2	1.1	8.1	2.9	4.9	3.0	6.7
Illustrative £-converted version *	0.8	-2.1	22.3	12.4	8.7	7.6	8.0
Euro relative to Sterling	1.0	2.7	5.7	3.1	1.7	2.7	-
US \$ relative to Sterling	-1.0	-3.7	2.9	9.6	3.8	4.4	1.2
Japanese Yen relative to Sterling	-2.2	-4.5	-6.0	5.9	-3.0	5.4	1.3
Sterling trade weighted	-0.3	-0.1	-4.0	-4.3	-1.4	-3.0	-1.1
Price Inflation (RPI) *	0.4	1.2	3.7	2.0	2.3	2.8	2.8
Price Inflation (CPI) *	0.4	1.2	2.9	1.1	1.5	2.4	2.0
Price Inflation (RPIX) *	0.4	1.2	3.9	2.1	2.4	3.1	2.8
Earnings Inflation **	-10.1	1.0	1.1	2.4	2.0	2.1	3.2
All Share Capital Growth	-2.8	0.3	13.8	3.6	6.7	1.6	3.1
Net Dividend Growth	1.4	4.4	12.3	7.1	6.3	4.4	-
Earnings Growth	0.5	3.4	27.3	-15.8	-11.4	-5.6	1.0

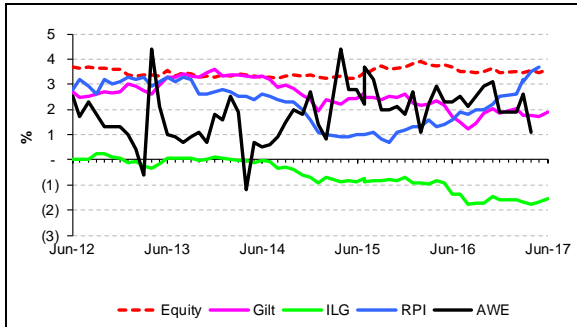
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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 – MSCI IPD UK Monthly Property 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.

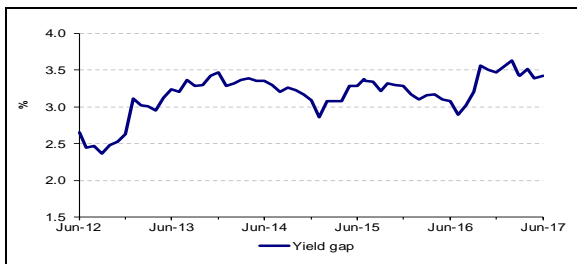


## Yields and Yield Gaps

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.

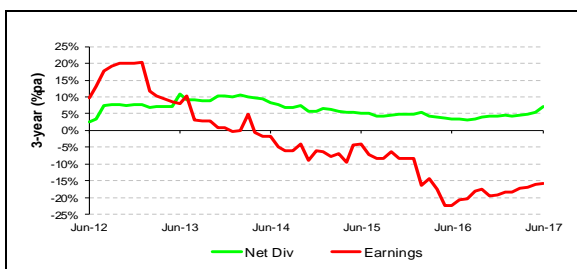
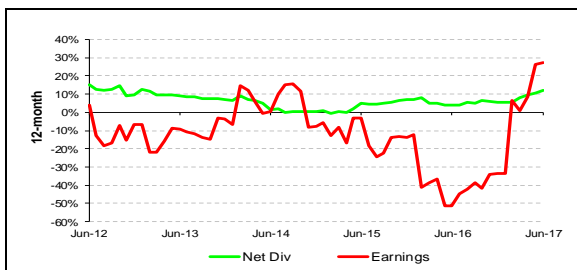


The gap gives a current expectation around 3.4% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

## 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]

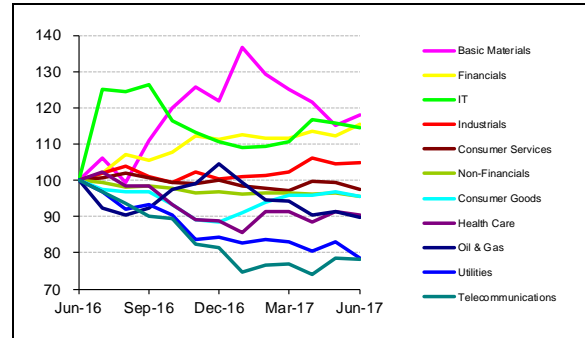
Figure 3: Dividend & Earnings Growth



Note: Earnings data from mid 2015 onwards is under review by FTSE Russell as one-off events may be affecting the prospective P/E ratios

## UK Equity Sector Returns

Figure 4a: Sectors relative to All Share



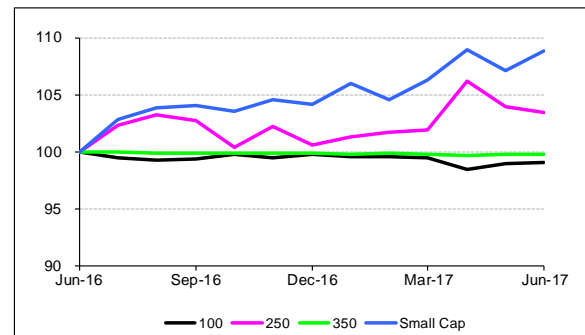
Note: Sector labels for relative lines are in end-value order

There was a fall this month in the rolling 12-month sector dispersion (from 55% to 40%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	-4.2	-3.3	6.0
Basic Materials	0.0	-4.2	39.5
Industrials	-2.0	4.1	24.0
Consumer Goods	-4.0	0.9	12.7
Health Care	-3.4	0.3	6.8
Consumer Services	-4.4	1.6	15.1
Telecommunications	-3.1	2.9	-7.7
Utilities	-8.0	-4.1	-7.4
Non-Financials	-3.5	0.2	12.7
Financials	0.5	5.0	36.4
IT	-3.5	4.8	35.2
All Share	-2.5	1.4	18.1

## UK Equity Size Returns

Figure 4b: Size groups relative to All Share



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

## FRS17 volatility indicator

Now discontinued, but available on request.

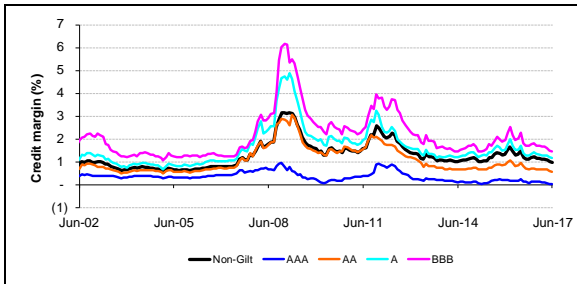
Sources for charts on this page:

Financial Times, Office for National Statistics, J&A



**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 '17	2.77	2.03	0.74
Feb '17	2.50	1.77	0.73
Mar '17	2.50	1.76	0.74
Apr '17	2.50	1.75	0.75
May '17	2.41	1.71	0.70
Jun '17	<b>2.55</b>	<b>1.89</b>	<b>0.66</b>

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

Category	Mkt Val @ Jun 17 & 14, 11			Weight (%)
	Jun 17	Jun 14	Jun 11	
Gilts (41)	1,349	1,095	832	70.7
Non Gilts (1,022)	560	537	469	29.3
AAA (130)	108	104	128	5.7
AA (167)	87	88	73	4.6
A (337)	168	171	163	8.8
BBB (388)	197	173	105	10.3

Category	Mkt Val @ Jun 17 & 14		W't (%)	Dur'n (yrs)
Gilts (41)	1,349	1,095	70.7	11.6
< 5 Yrs (11)	385	308	20.2	2.8
5-15 Yrs (11)	342	381	17.9	7.6
> 15 Yrs (19)	622	406	32.6	19.2
Non Gilts (1,022)	560	537	29.3	8.2
< 5 Yrs (347)	167	158	8.8	2.8
5-15 Yrs (448)	238	227	12.5	7.6
> 15 Yrs (227)	155	151	8.1	15.1

**£ Gilt Market “main” Issuance**

- o £2.87bn ½% 2022 (2.26x, 0.46%, Apr 17)
- o £2.50bn 1¼% 2027 (2.14x, 1.14%, Apr 17)
- o £2.59bn 1½% 2047 (2.12x, 1.67%, Mar 17)
- o £1.00bn 1/8% IL 2026 (3.10x, ry -1.97%, Feb 17)

Note: Issuance amounts are nominals.

**Tables 2d, 2e: € Market Size and Maturity (Jun 17)**

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (341)	5,871	59.7
Non Sovereigns	3,967	40.3
AAA (784)	1,153	11.7
AA (620)	997	10.1
A (855)	836	8.5
BBB (1,131)	980	10.0

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (791)	2,139	21.7
3 – 5 Yrs (1,009)	2,154	21.9
5 – 7 Yrs (792)	1,651	16.8
7 – 10 Yrs (756)	1,757	17.9
10+ Yrs (383)	2,138	21.7

**Table 2f: Breakdown of £ Index-Linked Market**

Category (Number of issues)	Mkt Val (£bn @ Jun 17 & 14)		W't (%)	Dur'n (yrs)
Gilts (28)	641	405	100.0	22.5
< 5 Yrs (3)	51	44	7.9	1.9
5 – 15 Yrs (7)	148	126	23.1	8.4
> 15 Yrs (18)	442	235	68.9	29.7

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

Month End	US (%)	Euro (%)	Sterling (%)
Jan '17	5.49	3.39	5.75
Feb '17	5.32	3.30	5.52
Mar '17	5.43	3.42	5.59
Apr '17	5.30	3.23	5.49
May '17	5.24	3.10	5.30
Jun '17	<b>5.32</b>	<b>3.09</b>	<b>5.42</b>

Sources: DMO, iBoxx, J&A, MLX

