JAGGER & ASSOCIATES

Investment Update
September 2020

Investment Headlines & Comment

- A comparatively quiet month for many asset classes.
- Sterling surrendered some of its summer gains.
- Near record demand (£76.2bn) for the new 2035 gilt.

Feature Section

This month marks the 250th edition of *Investment Update*. The number 250 does not seem to carry any great significance from an investment perspective but it is interesting to reflect on just how far things have changed since the first edition in December 1999.

Back then, long gilts yielded around 5%, with real yields in index-linked gilts of around 2%, and investment grade corporate bonds offered a credit margin slightly in excess of 1% p.a. For those willing to go into sub-investment grade (High Yield), the credit margin was in excess of 5% p.a. (although it was a much less widely-used asset class then, compared with now). The size of the gilt market was slightly under £300bn, and gilts with a 30-year maturity were still a relatively recent innovation (from the late 1990s), whereas now we see new gilt issues with lifetimes of 50 years or more.

Whilst those corporate bond credit margin and inflation expectations have remained comparatively stable across many of the intervening years, the current widespread pension fund mania for holding gilts at any price, with yields down by over 4%, will make a subject of interest for future generations of financial historians. At what stage might the Pensions Regulator be seen to have been causing harm through its guidance and actions? Similarly, following on from last month's feature, can Quantitative Easing ever be undone, and over what timeframe, and with what impact on markets?

In terms of the UK Equity market, the All Share (price) index is coincidentally at almost the same level now that it was in December 1999, so the total return over the intervening period is going to have been almost entirely dividend related, with no nominal capital growth (and hence, in real terms, a capital loss). It is also striking that as a proportion of the world equity market, the UK's weight has dropped from just under 10% down to just under 4%, with most of the shift occurring within the last decade.

In trade-weighted terms, Sterling has dropped by about 24% over the period, thus boosting the returns from Overseas Equities. The rise of mega stocks in the Technology area has also been striking – for example, Apple's weighting in the FT All-World index is now over 6%, and Microsoft's is over 5%. Back in December 1999, the peak of a Tech "dot-com" bubble was being approached, and some investors suffered badly. We know technology is so much more significant in our lives now, particularly in 2020 as the pandemic has played out, but it seems fair to ask if there is currently some risk of history repeating itself, e.g. if electric cars do not become commonplace, or fewer people upgrade to the next release of each gadget.

Meanwhile, pension fund asset allocation has changed dramatically. Back in December 1999, WM were reporting that the typical UK defined benefit pension scheme had 51% in UK Equities, 24% in Overseas Equities, 9% in Fixed Interest, and 4% in each of Index-Linked, Overseas Bonds, Property and Cash. This was not significantly different from the typical "managed fund" asset allocation available within pooled funds. Broad equality of UK and Overseas Equity weightings was seen by the mid 2000s, coupled with a shift of around 10% from equities to bonds over the same period. This move reflected a mix of growing scheme maturity, regulatory and accounting changes. Indeed, scheme maturity in 2020 implies that the majority of defined benefit schemes associated with small or medium-sized employers are likely to wind up in the next 10-15 years (although ultra-low long-dated gilt yields may defer this end date a bit).

One final change in asset allocation is worth a comment. Given the leverage employed within Liability Driven Investment (LDI), many schemes have effectively created a (large) negative quasi Cash weighting and a (larger) positive quasi Fixed Interest and Index-Linked position. Getting an asset allocation to add up to 100% (with only non-negative weightings) isn't what it used to be! It remains to be seen how painful rising short-term interest rates will be for LDI advocates, but in the current short term, we face the bizarre prospect of zero or negative rates. You wouldn't have ever imagined those in 1999.

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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 September 2020

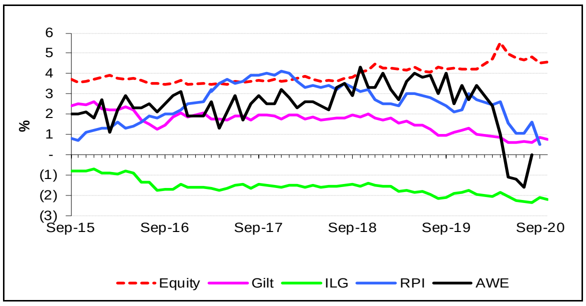
Asset Class	1 month (%)	3 months (%)	12 months (%)	3 years (% p.a.)	5 years (% p.a.)	10 years (% p.a.)	20 years (% p.a.)
UK Equities	**-1.7**	**-2.9**	**-16.6**	**-3.2**	3.5	5.1	3.9
Overseas Equities	0.4	3.7	6.9	9.6	15.1	11.7	6.6
US Equities	-0.4	4.7	**11.3**	**14.1**	**18.1**	**16.1**	5.6
Europe ex UK Equities	0.5	1.1	-0.3	3.0	10.3	7.6	7.3
Japan Equities	**5.0**	2.4	2.6	5.4	11.4	8.9	3.1
Pacific ex Japan Equities	1.2	4.6	8.4	5.9	13.7	7.4	**9.6**
Emerging Markets	-0.3	**4.8**	5.7	4.1	12.9	4.9	8.9
UK Long-dated Gilts	2.8	-2.5	5.2	9.5	8.6	8.7	7.2
UK Long-dated Corp. Bonds	1.3	0.5	6.2	7.9	9.0	8.1	7.4
UK Over 5 Yrs Index-Linked Gilts	1.8	-2.5	0.4	7.0	8.3	8.8	7.5
High Yield (Global)	2.1	0.3	-1.0	4.9	10.1	8.2	7.9
Overseas Bonds	3.6	-2.1	1.6	5.8	7.4	4.0	5.6
Property *	0.2	0.1	-2.9	3.5	4.8	7.6	7.2
Cash	0.0	0.0	0.5	0.6	**0.6**	**0.6**	**2.4**
Commodities £-converted	-0.6	0.0	-31.2	-8.3	-4.9	-7.0	-3.3
Hedge Funds original $ basis *	2.3	7.4	5.0	3.4	4.0	4.1	4.8
Illustrative £-converted version *	0.7	-0.4	-4.0	2.2	7.0	5.6	5.3
Euro relative to Sterling	1.6	-0.2	2.5	1.0	4.2	0.5	2.1
US $ relative to Sterling	3.1	-4.4	-4.7	1.2	3.2	2.0	0.7
Japanese Yen relative to Sterling	2.9	-2.3	-2.4	3.4	5.8	-0.4	0.8
Sterling trade weighted	-2.0	1.7	0.6	-0.4	-3.2	-0.3	-1.3
Price Inflation (RPI) *	-0.3	0.4	0.5	2.2	2.5	2.7	2.7
Price Inflation (CPI) *	-0.5	0.1	0.2	1.5	1.6	1.9	2.0
Price Inflation (RPIX) *	-0.3	0.4	0.8	2.3	2.6	2.8	2.9
Earnings Inflation **	1.3	1.2	0.0	2.4	2.3	2.1	2.8
All Share Capital Growth	-1.8	-3.8	-19.2	-6.8	-0.3	1.4	0.4
Dividend Growth	-0.7	-5.8	-12.5	0.1	3.9	5.1	4.2
Earnings Growth	-6.7	-31.4	-37.1	-1.4	-4.0	-2.2	1.4

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

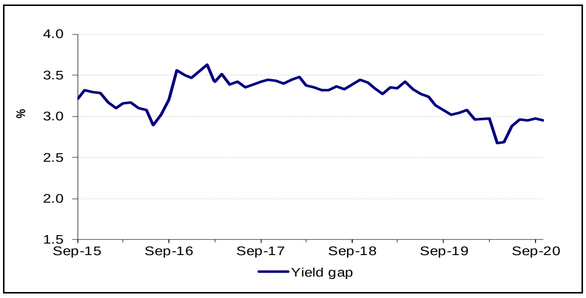
- *UK Equities (incl. dividends and earnings) – FT-A All Share.*
- *Overseas Equities (incl. regions) – blend of FT All-World / World sub-indices*
- *Emerging Markets from MSCI US $ based total return index (overall Index to 31 Oct 2001, Free Index from 1 Nov 2001 to take account of foreign investment 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 – ICE 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.

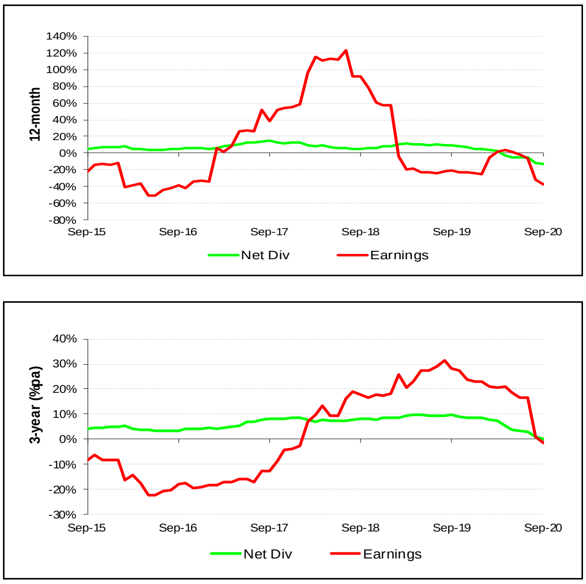


The gap gives a current expectation around 3.0% for longer-term inflation *including the risk premium for gilts, relative to index-linked gilts.*

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*]

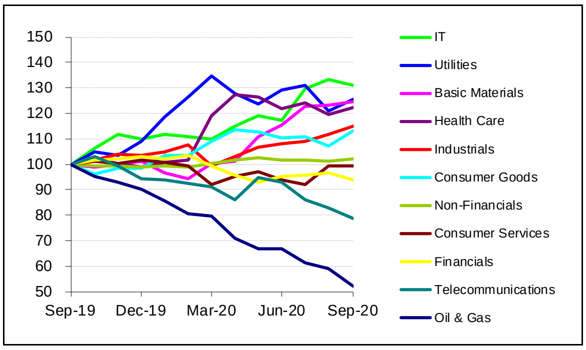
Figure 3: Dividend & Earnings Growth



Note: Earnings data from mid-2015 onwards is no longer reliable as one-off events may be affecting the prospective P/E ratios

UK Equity Sector Returns

Figure 4a: Sectors relative to All Share



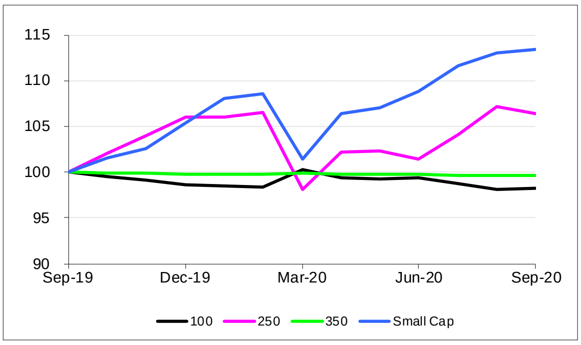
Note: *Sector labels for relative lines are in end-value order*

There was a rise this month in the rolling 12-month sector dispersion (up from 71% to 79%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	-13.2	-24.1	-56.5
Basic Materials	-0.5	4.7	3.8
Industrials	0.9	3.2	-4.3
Consumer Goods	3.9	-0.6	-5.8
Health Care	0.6	-2.3	2.1
Consumer Services	-1.3	3.0	-17.0
Telecommunications	-6.8	-17.8	-34.4
Utilities	1.9	-5.8	4.5
Non-Financials	-0.7	-2.4	-14.7
Financials	-4.5	-4.5	-21.7
IT	-3.4	8.7	9.3
All Share	-1.7	-2.9	-16.6

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



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

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

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Bond market information

Figure 5: £ Non-Gilt Credit Margins

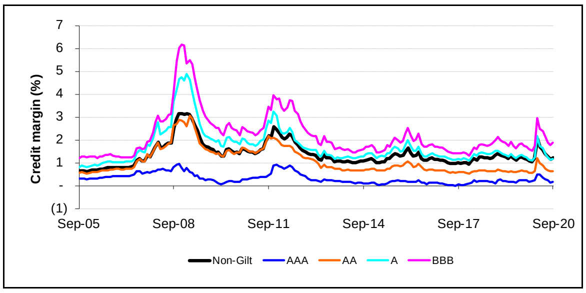

Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
Apr '20	1.57	0.60	0.97
May '20	1.52	0.59	0.93
Jun '20	1.45	0.64	0.81
Jul '20	1.37	0.60	0.77
Aug '20	1.60	0.86	0.74
Sep '20	**1.53**	**0.74**	**0.79**

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

Category	Mkt Val @ Sep 20 & 17, 14			Weight (%)
Gilts (47)	1,735	1,319	1,171	72.2
Non-Gilts (1,164)	670	568	549	27.8
AAA (147)	135	111	104	5.6
AA (155)	85	87	92	3.5
A (362)	189	160	175	7.9
BBB (500)	262	210	177	10.9

Category	Mkt Val (£bn @ Sep 20 & 17)		W't (%)	Dur'n (yrs)
Gilts (47)	1,735	1,319	72.2	13.2
< 5 Yrs (11)	392	372	16.3	2.8
5–15 Yrs (13)	509	374	21.2	7.8
> 15 Yrs (23)	834	572	34.7	21.3
Non-Gilts (1,164)	670	568	27.8	8.0
< 5 Yrs (427)	230	182	9.6	2.6
5–15 Yrs (501)	278	239	11.6	7.4
> 15 Yrs (236)	161	147	6.7	16.5

Tables 2d, 2e: € Market Size and Maturity (Sep 20)

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (398)	7,502	59.8
Non-Sovereigns	5,053	40.2
AAA (988)	1,409	11.2
AA (793)	1,163	9.3
A (1,244)	1,118	8.9
BBB (1,660)	1,364	10.9

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (1,236)	2,649	21.1
3 – 5 Yrs (1,335)	2,517	20.0
5 – 7 Yrs (996)	2,020	16.1
7 – 10 Yrs (851)	2,169	17.3
10+ Yrs (665)	3,201	25.5

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Sep 20 & 17)		W't (%)	Dur'n (yrs)
Gilts (28)	796	643	100.0	22.1
< 5 Yrs (3)	70	51	8.8	3.1
5 – 15 Yrs (8)	201	149	25.2	9.8
> 15 Yrs (17)	525	443	65.9	29.4

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

Month End	US (%)	Euro (%)	Sterling (%)
Apr '20	6.94	4.94	7.38
May '20	6.04	4.38	6.60
Jun '20	5.96	4.05	5.88
Jul '20	5.11	3.69	5.62
Aug '20	4.98	3.45	5.32
Sep '20	**5.33**	**3.66**	**5.47**

Sources: DMO, FTSE, iBoxx, ICE, J&A

£ Gilt Market "main" Issuance

- During the expanded gilt issuance programme, there is insufficient space here to list all the auction / tender exercises, so please click here for the details.

Note: Issuance amounts are nominals. The first % figure in each row is the yield or real yield. The second % figure is the additional amount taken up under the Post Auction Option Facility (PAOF), as a % of the amount of the issue. No PAOF applies for tender or syndication cases.

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