JAGGER & ASSOCIATES

Investment Update
January 2021

Investment Headlines & Comment

- A relatively calm month overall, with Sterling rising.
- Nominal and real yields on bonds have risen slightly.
- Notable £57bn of demand for this month's new 25-year gilt.

Feature Section

This month we consider how defined benefit pension schemes are being rightly encouraged (or perhaps wrongly pressurized) on the subject of climate change.

It is common for charities to apply constraints on their investments (e.g. no tobacco), and some go further with adopting sustainability criteria (such as the United Nations Sustainable Development Goals (SDGs). However, it is rarer for DB pension schemes to do so, possibly because of past cases such as those discussed in our November 2019 edition. Trustees may simply be unable to demonstrate that applying such criteria does not adversely affect their expected investment return (particularly if they are investing in companies who are operating quite legitimately under the laws of the countries in which they do business). In turn, sponsoring employers may thus be unhappy at the increased costs if Trustees do look to make such changes.

The recent Pensions Bill has brought into force recommendations by the Task Force on Climate-related Financial Disclosures (TCFD), although at this stage it is only for schemes over £5bn, with schemes over £1bn following in a year's time. Those schemes are asked to consider *transition risks* (the risks and opportunities from the realignment of world economic systems towards climate-resilient solutions, whether via regulations or market forces), and *physical risks* (such as the increased frequency and severity of extreme weather events). There is huge uncertainty in the existing climate change modelling, not least because of trying to predict the degree of agreement that can be reached between governments. Also, there is the potential for market shocks if and when a market significantly re-prices climate risks (e.g. in respect of fossil fuels, a potential "stranded asset"). Further, what may be considered "prudent" in relation to climate-related risks today might no longer meet that standard in the future, so regular reassessment seems inevitable.

However, for pension schemes linked to small or medium-sized employers, many such schemes are likely to be wound up in the next 10-15 years, and their investment strategies will become increasingly mature. They seem less likely to be affected by transition risks and physical risks, unless governments fail to make headway (but progress seems more likely now that a certain person is no longer President in the USA).

These schemes are also highly likely to be investing via pooled funds, so it will be for their investment managers to assess and manage climate-related risks, rather than for Trustees to formulate their own assessments of their investments. (If legislation comes in that forces the latter approach, we suspect the additional governance time will accelerate employers' desires to get these schemes bought out and wound up.) Recent ESG changes to a scheme's Statement of Investment Principles, as covered in our June 2018 edition, are already leading to better reporting by managers, although so far it seems to be more at the overall manager level, and not necessarily at the level of the specific fund(s) held by a particular scheme. We envisage that this ESG reporting will evolve over time, and will in due course lead to managers reporting along the lines of eleven TCFD recommended disclosures. The volume of information may become overwhelming, but hopefully that will all be in electronic form, to avoid yet more deforestation.

Further, under TCFD, each scheme should identify and assess the materiality of climate-related risks and opportunities to their sponsoring employer, and their assessment of their employer's resilience to different scenarios. In many cases, the sponsoring employer will already be monitoring this (e.g. to meet their own TCFD obligations), and they may simply agree to show their Trustees what analysis they have undertaken.

Finally, it seems clear that defined contribution scheme Trustees can reasonably offer a range of ethical or environmental funds to their members if they wish to adopt climate-change related positions, but much less clear that DC Trustees should impose their own beliefs by using specific such funds within their default strategy (given that most scheme members are not very financially minded, and simply go with the default).

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 January 2021

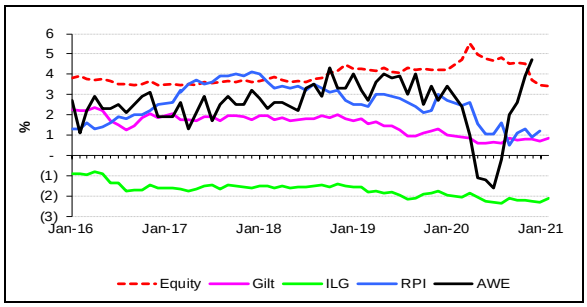
Asset Class	1 month (%)	3 months (%)	12 months (%)	3 years (% p.a.)	5 years (% p.a.)	10 years (% p.a.)	20 years (% p.a.)
UK Equities	-0.8	**16.1**	**-7.5**	**-0.5**	5.6	5.5	4.5
Overseas Equities	-0.9	10.1	13.8	10.2	15.4	11.6	7.1
US Equities	-1.4	8.3	14.6	**13.8**	**17.5**	**15.5**	5.7
Europe ex UK Equities	-2.2	14.0	7.2	4.7	11.2	7.5	7.7
Japan Equities	-1.4	8.9	10.8	5.4	11.3	8.5	4.3
Pacific ex Japan Equities	**2.8**	13.7	**26.9**	8.3	16.3	8.6	**10.3**
Emerging Markets	2.6	13.9	23.2	6.0	16.2	6.2	9.7
UK Long-dated Gilts	-3.1	-1.0	3.9	8.6	7.4	9.3	6.8
UK Long-dated Corp. Bonds	-2.5	3.6	5.7	8.4	9.2	9.1	7.2
UK Over 5 Yrs Index-Linked Gilts	**-3.3**	-2.7	3.8	5.9	7.4	8.8	7.3
High Yield (Global)	-0.4	1.0	3.6	6.7	9.6	8.0	7.8
Overseas Bonds	-1.8	**-5.1**	2.0	5.2	4.7	3.8	5.0
Property *	1.0	2.0	-1.0	2.8	4.4	7.6	7.2
Cash	0.0	0.0	0.2	0.6	**0.5**	**0.6**	**2.3**
Commodities £-converted	4.5	17.3	-13.8	-5.6	0.8	-7.2	-2.8
Hedge Funds original $ basis *	4.4	10.7	11.6	5.5	6.1	4.2	5.5
Illustrative £-converted version *	2.0	4.7	8.2	5.1	7.7	5.6	6.0
Euro relative to Sterling	-1.2	-1.8	5.2	0.3	3.0	0.3	1.7
US $ relative to Sterling	-0.5	-5.8	-4.0	1.2	0.7	1.6	0.3
Japanese Yen relative to Sterling	-1.8	-6.0	-0.6	2.6	3.6	-0.9	0.8
Sterling trade weighted	1.1	2.5	-1.9	-0.1	-2.0	-0.1	-1.0
Price Inflation (RPI) *	0.6	0.4	1.2	2.0	2.5	2.6	2.7
Price Inflation (CPI) *	0.3	0.1	0.6	1.3	1.7	1.8	2.0
Price Inflation (RPIX) *	0.6	0.4	1.4	2.1	2.6	2.7	2.8
Earnings Inflation **	0.7	3.1	4.7	3.8	3.4	2.5	2.9
All Share Capital Growth	-0.9	15.6	-10.2	-4.2	1.8	1.8	0.9
Dividend Growth	-1.4	-12.4	-27.6	-6.4	-0.5	3.5	3.2
Earnings Growth	-3.1	3.6	-25.8	-4.5	-1.8	-2.9	1.5

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

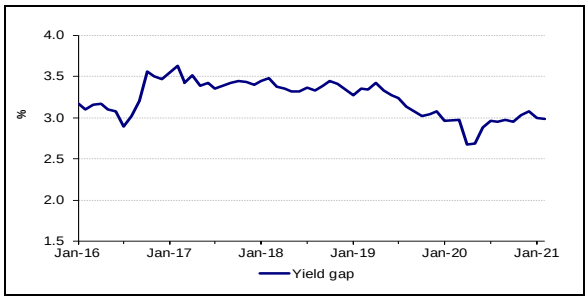
- *UK Equities (incl. dividends and earnings) – FT-A All Share.*
- *Overseas Equities (incl. regions) – blend of FT All-World / World sub-indices*
- *Emerging Markets from MSCI US $ based total return index (overall Index to 31 Oct 2001, Free Index from 1 Nov 2001 to take account of foreign investment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

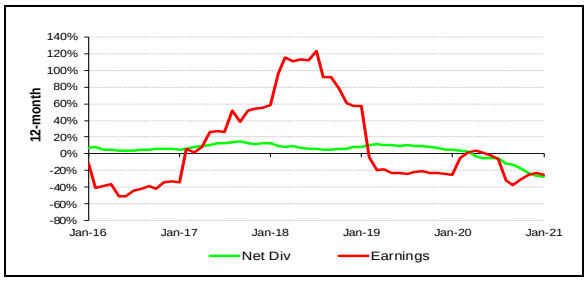


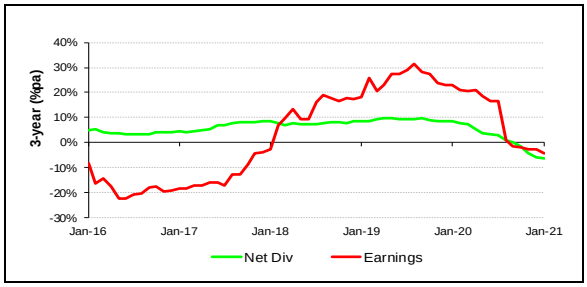
The gap gives a current expectation around 3.0% for longer-term inflation *including the risk premium for gilts, relative to index-linked gilts.*

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

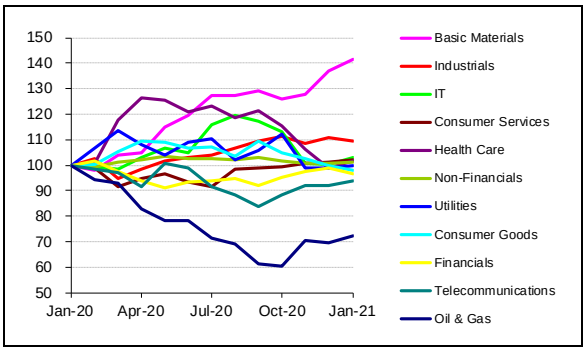




Note: Earnings data from mid-2015 onwards is no longer reliable as one-off events may be affecting the prospective P/E ratios

UK Equity Sector Returns

Figure 4a: Sectors relative to All Share



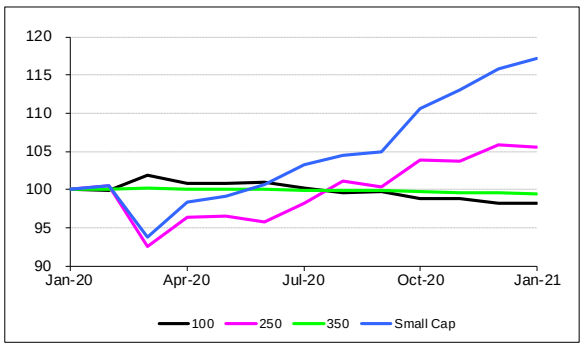
Note: Sector labels for relative lines are in end-value order

There was a small rise this month in the rolling 12-month sector dispersion (up from 65% to 69%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	3.3	39.4	-33.0
Basic Materials	2.4	30.3	30.7
Industrials	-2.1	14.3	1.0
Consumer Goods	-2.9	8.2	-9.5
Health Care	2.0	2.1	-6.2
Consumer Services	0.1	19.3	-5.5
Telecommunications	1.0	23.4	-13.4
Utilities	0.0	3.2	-7.9
Non-Financials	-0.1	15.6	-6.5
Financials	-2.8	17.8	-10.6
IT	2.2	6.0	-4.7
All Share	-0.8	16.1	-7.5

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



This month, Mid Cap fell slightly whereas Small Cap rose, relative to the All Share.

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

Bond market information

Figure 5: £ Non-Gilt Credit Margins

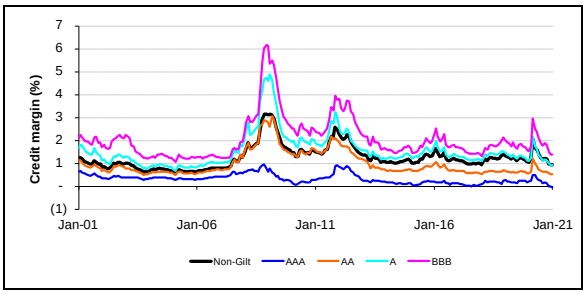


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
Aug '20	1.60	0.86	0.74
Sep '20	1.53	0.74	0.79
Oct '20	1.65	0.79	0.86
Nov '20	1.52	0.82	0.70
Dec '20	1.34	0.70	0.64
Jan '21	**1.51**	**0.85**	**0.66**

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

Category	Mkt Val (£bn @ Jan 21 & 18, 15)			Weight (%)
Gilts (49)	1,797	1,336	1,279	72.9
Non-Gilts (1,144)	669	565	567	27.1
AAA (129)	125	107	101	5.1
AA (144)	80	78	95	3.3
A (370)	192	166	188	7.8
BBB (501)	271	215	183	11.0

Category	Mkt Val (£bn @ Jan 21, 18)		W't (%)	Dur'n (yrs)
Gilts (49)	1,797	1,336	72.9	13.0
< 5 Yrs (12)	425	399	17.2	2.8
5–15 Yrs (14)	524	355	21.3	8.0
> 15 Yrs (23)	847	581	34.4	21.2
Non-Gilts (1,144)	669	565	27.1	8.1
< 5 Yrs (416)	226	180	9.2	2.8
5–15 Yrs (496)	281	234	11.4	7.5
> 15 Yrs (232)	161	151	6.5	16.7

Tables 2d, 2e: € Market Size and Maturity (Jan 21)

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (400)	7,562	59.2
Non-Sovereigns	5,214	40.8
AAA (996)	1,411	11.0
AA (798)	1,227	9.6
A (1,246)	1,128	8.8
BBB (1,739)	1,449	11.3

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (1,262)	2,624	20.5
3 – 5 Yrs (1,316)	2,540	19.9
5 – 7 Yrs (1,035)	2,069	16.2
7 – 10 Yrs (861)	2,212	17.3
10+ Yrs (705)	3,331	26.1

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Jan 21 & 18)		W't (%)	Dur'n (yrs)
Gilts (29)	788	640	100.0	21.7
< 5 Yrs (3)	69	59	8.8	2.8
5 – 15 Yrs (9)	201	150	25.5	9.5
> 15 Yrs (17)	518	431	65.6	28.9

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

Month End	US (%)	Euro (%)	Sterling (%)
Aug '20	4.98	3.45	5.32
Sep '20	5.33	3.66	5.47
Oct '20	5.29	3.62	5.32
Nov '20	4.65	2.85	4.47
Dec '20	4.38	2.74	4.32
Jan '21	**4.43**	**2.74**	**4.20**

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.

JAGGER & ASSOCIATES

Contact: Ground Floor, 14 Exchange Quay,
Salford Quays, Manchester M5 3EQ
Tel.: 0161 873 9350, Fax: 0161 877 4851
web: www.jaggerandassociates.co.uk
e-mail: enquiries@jaggerandassociates.co.uk

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