

## Investment Update February 2003



### Investment Headlines & Comment

- S&P's review of post-retirement liabilities at more than 500 rated European companies has led to some 10 European corporates being placed on CreditWatch, which is one step short of outright downgrading. The list did not include Invensys, but in the light of that company's dramatic share price fall this month and their known large pension fund, it is likely that their covenant position is getting ever tighter.
- The returns table on page 2 now shows **UK Equities** as the worst-performing asset class over 5 years. See the feature item below for more on whether this means there is now a buying opportunity either here or in the US.
- **Jagger & Associates** have good news for Trustees struggling with GMP equalization. For schemes that used fixed rate GMP revaluation, the revaluation rate is

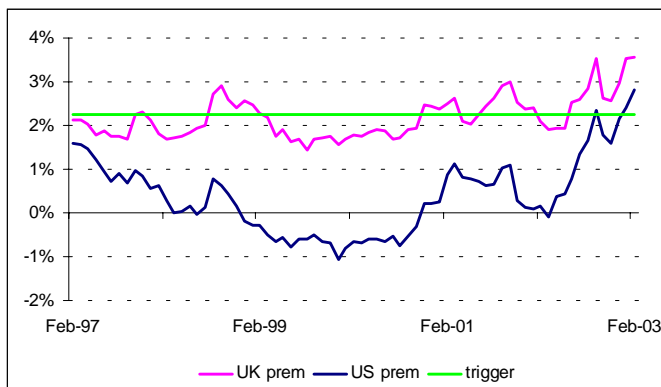
often above the discount rate that would now apply for valuing the deferred benefits. So, for males taking benefits at age 60, giving up the revaluation to age 65, these can have similar value to taking the higher benefits from age 65. So, some schemes may be able to progress their wind-ups even though the fine detail of GMP equalization is still awaited, and thus reduce the erosion of benefits by professional fees.

### Feature Section

Following on from last month's analysis of the UK Equity market's risk premium, this month Dave Greenall does the same for the US Equity market, and also considers the relative merits of the US and UK index-linked government bond markets. TIPS, the US equivalent of UK index-linked gilts, only began in 1997, so the periods covered by the charts are shorter than the 10 years used in last

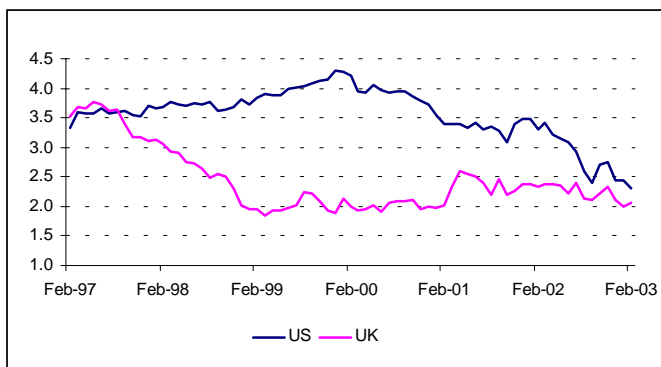
month's feature section. Using the method outlined in last month's *Update*, Figure 1a shows the equity risk premium results for the two markets. The constant line, which we have called the "trigger level", is meant as an example of an investor's (subjective) view of the risk premium above which they would regard UK (or US) equities as particularly cheap relative to index-linked gilts (to TIPS).

**Figure 1a US and UK Equity Risk Premia**



The chart shows that US Equities have been consistently expensive since TIPS were introduced. Indeed, between Jan 1999 and November 2000, the US risk premium was actually negative, implying extreme over-pricing relative to TIPS. It is only in recent months that US risk premium levels have returned to the area generally occupied by UK Equities during the last 6 years.

**Figure 1b US and UK real yields**



Now how comparable are the yields on UK index-linked gilts and US TIPS? Figure 1b shows the yields have varied significantly. In the period to March 1999, UK yields dropped significantly, probably through increased demand from institutional investors (particularly pension funds).

Curiously, US real yields rose over this period and on into early 2000. This was an opportunity for those wanting some inflation-linking but viewing UK index-linked stocks as overpriced. Even if any currency mismatch was hedged, there would have been some mismatching of inflation types for investors, but the added value from TIPS at that time seems pretty clear. Over the next 3 years, TIPS yields have reduced significantly, partly as this opportunity was exploited by investors.

The TIPS market has expanded significantly since inception, with a market value of about \$57bn as at September 1998, and now valued at about \$150bn. It accounts for almost half of the world-wide index-linked market.

For comparison, the UK market's value has been at around \$100bn over the past 4 years. However, the increased move by UK pension funds from equities into bonds, with an associated need for index-linked (rather than conventional) stock suggests that this constant level may now be set to rise.

Sources: *Financial Times*, Bloomberg, Jagger & Associates



## Asset Class Returns

The following table gives the latest returns for the main asset classes, currency returns, prices and earnings inflation, together with dividend and earnings growth. The cells in bold with light shading show the best and worst performing asset classes from each column.

**Table 1: Investment Data to 28 February 2003**

Asset Class	1 month (%)	3 months (%)	12 months (%)	3 years (% p.a.)	5 years (% p.a.)	10 years (% p.a.)
UK Equities	2.6	-11.6	-26.4	-13.9	<b>-5.7</b>	5.8
Overseas Equities	2.7	-10.1	-28.2	-15.6	-3.1	4.4
US Equities	2.9	-11.0	<b>-30.8</b>	-14.3	-2.3	7.2
Europe ex UK Equities	0.7	<b>-11.8</b>	-28.3	-17.8	-4.6	6.2
Japan Equities	5.5	-6.4	-17.8	<b>-21.7</b>	-5.2	<b>-4.1</b>
Pacific ex Japan Equities	0.7	-7.4	-20.2	-9.9	-3.2	0.5
Emerging Markets	1.8	-7.4	-22.0	-15.3	-3.8	-0.1
UK Long-dated Gilts	<b>-0.2</b>	4.8	10.6	5.8	8.3	10.7
UK <b>Long-dated</b> Corp. Bonds	0.4	5.0	9.9	<b>9.3</b>	9.2	-
UK Index-Linked Gilts	1.4	6.1	10.8	5.3	7.5	7.6
Overseas Bonds	<b>6.1</b>	<b>6.6</b>	<b>11.4</b>	8.6	6.9	5.3
Property *	0.6	2.3	10.6	9.2	<b>10.8</b>	<b>11.4</b>
Cash	0.3	1.0	4.0	5.0	5.6	6.0
Euro relative to Sterling	4.7	7.0	11.8	3.9	-	-
US \$ relative to Sterling	4.6	-1.1	-10.0	0.1	0.9	-1.0
Price Inflation *	-0.1	0.3	2.9	2.3	2.3	2.6
Earnings Inflation **	2.9	4.7	3.2	3.5	4.2	4.0
All Share Capital Growth	2.1	-12.2	-28.7	-16.2	-8.1	2.3
Net Dividend Growth	-0.2	-0.9	-1.7	0.5	0.4	-
Earnings Growth	1.7	-0.9	-10.5	-4.1	-4.7	3.4

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

- UK Equities (including dividends and earnings) – FT-A All Share.
- Overseas Equities (including regions) – blend of FT All-World / World subindices, allowing for an assumed rate of 15% withholding tax, Emerging Markets from MSCI US \$ based total return index (overall Index to 31 Oct 2001, Free Index from 1 Nov 2001 – this latter index takes account of foreign investment restrictions), converted to UK £ internally by J&A. Similarly, for the FT-based overseas returns, they are approximate conversions of the FTSE US \$ denominated data into a format consistent with the previous FTSE-published sterling denominated data.
- UK Bonds – FT-A Gilt indices (Gilts Over 15 Years, ILG All Stocks)
- UK Corporate Bonds – Barclays Capital Non-Gilt **Over 15 Year** index (all credit ratings combined)
- Overseas Bonds – JP Morgan Traded Unhedged World ex UK
- Property – IPD Index
- Cash – an indicative index based on the three-month London Interbank Sterling mid-rate, calculated internally by J&A
- Price and earnings inflation – Retail Prices Index, and the National Average Earnings Index (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.

## Comment

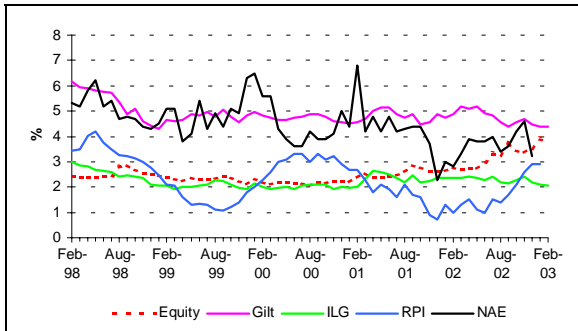
- The main effect this month has been from currency – both the Euro and the US dollar strengthened against Sterling, and as a result Overseas Bonds are the best performing asset class for periods up to a year. However, there is a marked differential in the currency movements over the 12 months as a whole.
- Remarkably, UK Equities are now the worst-performing asset over the last 5 years. Property continues to hold its position as the best-returns class over longer periods, but note our previous issues' caveats!



## Yields and Yield Gaps

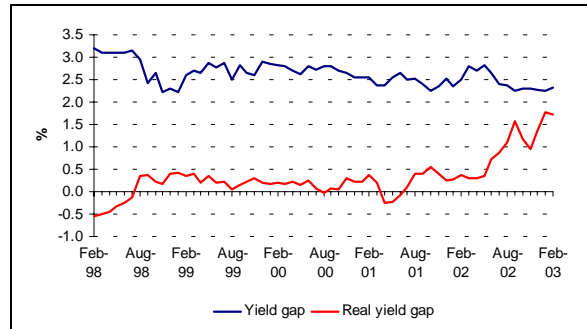
Figure 2 shows the movement in equity and bond yields over the last 5 years, together with rolling 12-month earnings and inflation data. These give a useful summary of market influences. Figure 3 shows the movement in the real yield gap (equity yield minus ILG yield) and the yield gap (a measure of expected average future inflation, derived as long bond yield minus ILG yield).

**Figure 2: Yields and Inflation**



Sources: Financial Times, Office for National Statistics

**Figure 3: Equity & Bond yield gaps**



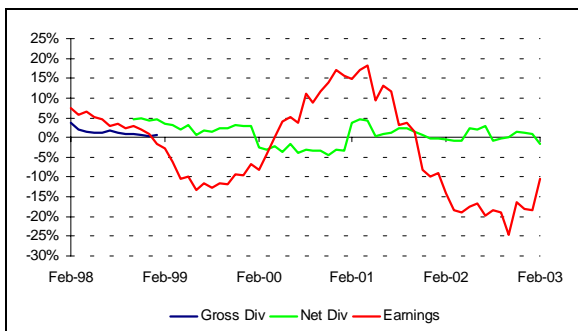
Sources: Financial Times, Jagger & Associates

Both price and wage inflation are showing some signs of rising, and wage inflation is becoming more variable, but the underlying inflation figure remains close to the government target. The yield gap has stayed below the existing government target of 2.5% pa.

## Growth in Earnings and Dividends

The following chart shows the movement in rolling 12-month dividend and earnings growth for UK Equities over the last 5 years.

**Figure 4: Dividend & Earnings Growth**



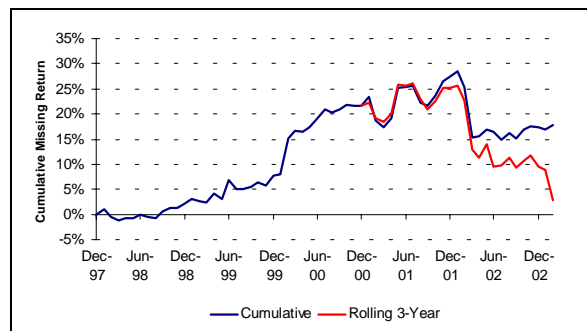
Sources: Financial Times, Jagger & Associates

The 12-month earnings results continue to be poor. The 3-year dividend growth is 0.5% p.a. compared with -0.9% p.a. at the end of January. The 3-year earnings growth is -4.1% p.a. as at the end of February, having been -5.1% p.a. as at the end of January.

## MFR / Valuation Inconsistencies

The following chart shows the large 'missing return' element for pension funds from the equity part of their MFR valuations, and its rolling 3 year value.

**Figure 5: MFR missing return**



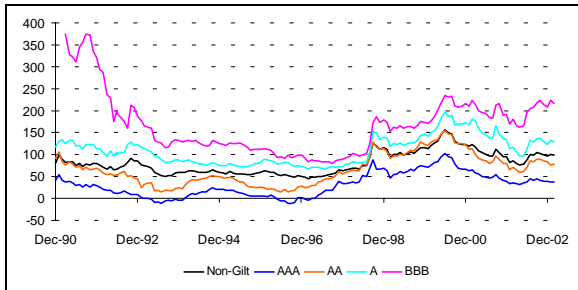
Sources: Financial Times, Jagger & Associates

If a scheme tracks the All Share Index, for its MFR equity-backed liabilities, then even though the assets and liabilities are allegedly matched, the liabilities in fact grow at a different rate to the assets, the so-called "missing return" – the latest 3 year period sees a major reduction, as the Vodafone-Mannesmann effect from early 2000 now drops out.



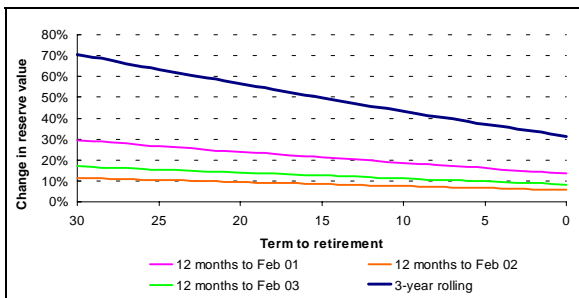
**FRS17 volatility and Corporate Bond market information**

**Figure 6a: Credit Margin**  
Basis points (units of 0.01%) relative to gilts



Note 1: BBB stocks were very sparse prior to 1993; thus earlier data should not be taken as very reliable  
 Note 2: Table 2c includes Gilt irredeemables under the > 15 Yrs category for simplicity.  
 Note 3: Small figures in Tables 2b,c are for 12 months earlier.  
 Sources: Barclays Capital (ex Fig 6b), Jagger & Associates

**Figure 6b: FRS17 volatility indicator**  
12 month and 36 month change in active reserve



Eg: A scheme whose actives on average now have 15 years to retirement will have seen their FRS17 liability value grow by 13% over the last 12 months, and by 50% over the last three years, which is 14% per annum. These can be compared with the market returns in Table 1.

**Table 2a: Trends in Long-dated AA Credit Margins**

Month End	AA rated Yield (%)	Gilt Yield (%)	Credit Margin (%)
Sep 2002	5.30	4.36	0.94
Oct 2002	5.46	4.53	0.93
Nov 2002	5.57	4.67	0.90
Dec 2002	5.32	4.49	0.83
Jan 2003	5.15	4.37	0.78
Feb 2003	5.16	4.41	0.75

**Table 2b: Breakdown of Market Size**

Category	Market Value (£bn @ 28 Feb 03 & 02)		Weight (%)
Gilts	225	212	46.2
Non Gilts	262	232	53.8
AAA	101	92	20.9
AA	34	44	7.0
A	79	57	16.2
BBB	40	31	8.1
Not rated	8	8	1.6

**Table 2c: Breakdown of Market Maturity**

Category	Mkt Val (£bn @ 28 Feb 03 & 02)		W't (%)	Dur'n (yrs)
Gilts	225	212	46.2	7.8
< 5 Yrs	69	69	14.2	2.8
5 – 15 Yrs	88	77	18.1	7.2
> 15 Yrs	67	66	13.8	13.8
Non Gilts	262	232	53.8	8.5
< 5 Yrs	56	59	11.5	2.7
5 – 15 Yrs	98	80	20.1	7.0
> 15 Yrs	108	93	22.2	12.9

**FRS17 and Corporate Bond Comment**

- The most noticeable point is the reduction in the size of the AA market – principally due to downgrades. By extension, the scope for FRS17 distortions must grow as the market diminishes.
- There is to be a new long gilt issue, maturing in 2036 – but will any companies want to commit to terms on which to borrow for that long?

