# JAGGER & ASSOCIATES

## Investment Update
## *January 2005*

## Investment Headlines & Comment

- The proportion of (mostly long-dated) **index-linked gilt** borrowing is set to increase with the latest DMO consultation considering £10bn of issuance in the next year. More details will come with the Budget.
- Trustees of **money purchase** schemes with Lifestyle strategies may need two versions from 2006, with the new one to cater for those taking all cash because of the increase for “trivial pensions” (to a cash limit of £15,000).
- The law of unintended consequences is at work again, this time on “freedom of information”. Local authorities are being asked to disclose details of their **Private Equity**, which many managers will dislike.

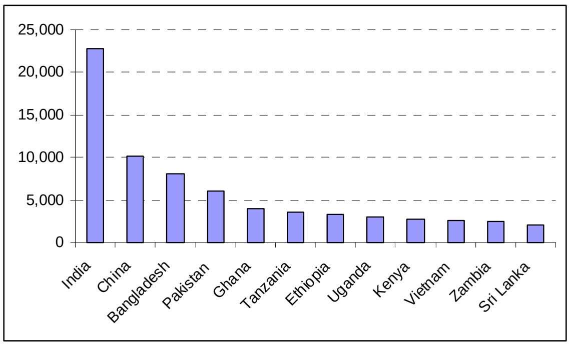
## Feature Section

This month, given the heightened interest in Third World debt, and the importance (or perception) of the writing off of interest, we thought brief financial background on the World Bank and debt relief was in order. Rick Alderson reports.

The World Bank is not really a “bank” but one of the United Nations’ specialized agencies consisting of five closely associated institutions owned by the 184 member countries. The term "World Bank" refers specifically to two of the five, the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA). The IBRD aims to reduce poverty in middle-income and creditworthy poorer countries by promoting sustainable development through loans, guarantees and advisory services. The IBRD raises almost all its money in the world’s financial markets. The income that the IBRD has generated over the years through interest on its loans enables it to borrow in the market at lower rates than these countries would be able to achieve on their own.

The IDA provides approximately $6bn to $9bn a year in *interest-free* loans to the world’s 81 poorest countries, defined as those with an income of less than $865 per person per year (as at 2002). These countries account for a staggering 2.5 billion people, half of the total population of the developing world. The IDA is mainly funded by contributions from the world’s wealthy countries. Since the IDA began, their total contributions have amounted to US$120bn (at the end of June 2003). Figure 1 below shows the amount of outstanding credits owed to the IDA in US$m. India is by far the largest single beneficiary of IDA credits, owing more than twice the amount owed by the next largest borrower China.

**Figure 1: IDA Outstanding Credits**




The Chancellor spoke on the subject of debt relief during his recent Africa tour, stating that “when many developing countries are still choosing between servicing their debts and making the investments in health, education and infrastructure that would allow them to achieve the Millennium Development Goals, we know we must do more.” He subsequently signed a Memorandum of Understanding between the UK and Tanzania which will enable the UK to begin making payments for 10% of Tanzania’s debt service to the World Bank and African Development Bank in their stead – benefiting Tanzania by $74m over the next ten years. Similarly, Mozambique should benefit by$46m over the same period.

This offer is being rolled out not just to the 37 Heavily Indebted Poor Countries (known as HIPC) but to all low income countries, as long as they can ensure debt relief is used for poverty reduction. At this stage, the gesture appears to be “relatively small” in its cost to the UK, but “big” in its potential benefit to the countries involved.

However, some commentators have raised doubts about this approach. The argument runs that if debts owed to the World Bank are paid off by richer countries, then there is less money to give to others and because there are some very poor countries without debt, this is unfair. To these commentators, it is not a "mystical solution" to poverty, rather it is just an equivalent of giving aid. Some, such as Clare Short, who quit the government over the war in Iraq, think the biggest causes of poverty in Africa are "failed states" such as Sudan and the Democratic Republic of Congo, and instead she believes in “really strong action to end conflict, arms supply, and to start building order, with the basic institutions of a state". It’s hard to disagree with that.

## Asset Class Returns

The cells in bold with light shading show the best and worst performing asset classes from each column. The $-based and unhedged-£-conversion hedge fund returns are excluded from this.
[**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 2005

| Asset Class | 1 month (% ) | 3 months (% ) | 12 months (% ) | 3 years (% p.a.) | 5 years (% p.a.) | 10 years (% p.a.) |
|---|---|---|---|---|---|---|
| UK Equities | 1.3 | 6.8 | 15.3 | 2.6 | -1.0 | 8.5 |
| Overseas Equities | -0.5 | 4.1 | 7.0 | -1.8 | -3.7 | 6.4 |
| US Equities | -0.6 | 2.1 | **2.7** | **-6.3** | -4.9 | 9.4 |
| Europe ex UK Equities | **-0.7** | 7.0 | 12.9 | 3.5 | -1.1 | 9.3 |
| Japan Equities | -0.3 | 5.0 | 7.6 | 4.5 | **-8.6** | **-3.3** |
| Pacific ex Japan Equities | 2.0 | 9.8 | 14.3 | 7.6 | 2.8 | 3.2 |
| Emerging Markets | **2.2** | **12.0** | 17.9 | 10.4 | 1.5 | 2.8 |
| UK Long-dated Gilts | **-0.7** | 2.1 | 7.9 | 5.4 | 5.4 | 9.9 |
| UK **Long-dated** Corp. Bonds | 0.8 | 3.6 | 9.3 | 7.0 | 8.5 | - |
| UK Index-Linked Gilts | -0.2 | 2.2 | 8.3 | 7.6 | 5.8 | 8.0 |
| Overseas Bonds | 0.5 | **0.8** | 4.5 | 4.1 | 5.7 | 5.4 |
| Property * | 2.0 | 5.0 | **19.0** | **13.5** | **11.6** | **11.2** |
| Cash | 0.4 | 1.2 | 4.7 | 4.2 | 4.7 | 5.7 |
| | | | | | | |
| Hedge Funds original $ basis * | 1.6 | 5.3 | 9.0 | 8.7 | 7.1 | 12.6 |
| Illustrative £-converted version * | 1.2 | -0.6 | 1.6 | -0.9 | 3.4 | 10.3 |
| | | | | | | |
| Euro relative to Sterling | -2.3 | -0.5 | 1.2 | 4.3 | 2.7 | - |
| US $ relative to Sterling | 1.9 | -2.5 | -3.3 | -9.2 | -3.0 | -1.7 |
| | | | | | | |
| Price Inflation (RPI) * | 0.5 | 1.0 | 3.5 | 3.1 | 2.6 | 2.7 |
| Price Inflation (CPI) * | 0.5 | 1.0 | 1.6 | 1.5 | 1.3 | 1.6 |
| Price Inflation (RPIX) * | 0.5 | 0.9 | 2.5 | 2.6 | 2.4 | 2.5 |
| Earnings Inflation ** | 0.4 | 1.2 | 4.5 | 4.0 | 3.9 | 4.0 |
| | | | | | | |
| All Share Capital Growth | 1.3 | 6.2 | 11.6 | -0.7 | -3.9 | 5.1 |
| Net Dividend Growth | 0.3 | 2.5 | 7.7 | 3.7 | 1.4 | - |
| Earnings Growth | -3.8 | -1.2 | 24.9 | 7.6 | 5.5 | 5.2 |

*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 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*
- *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 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.*

- Property's 2004 return of 19% was the 12th consecutive positive year, and 9 of these were in excess of 10%. This year's return is the highest of all 12!

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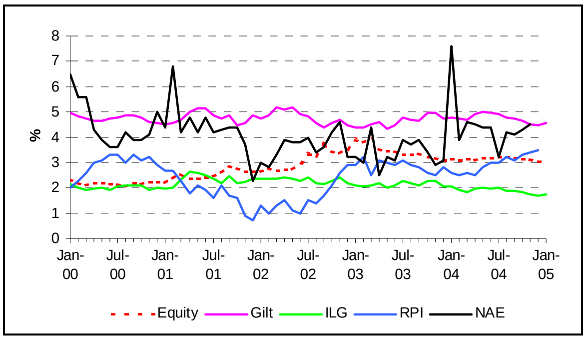
**Investment Update**

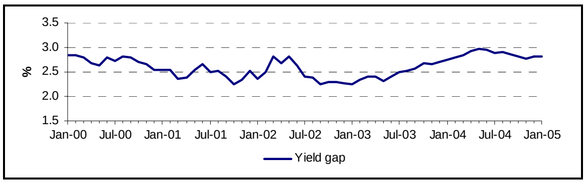
***January 2005***

## 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.



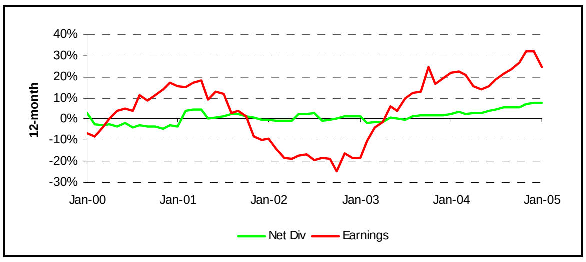

*Sources:* *Financial Times, Office for National Statistics, Jagger & Associates*

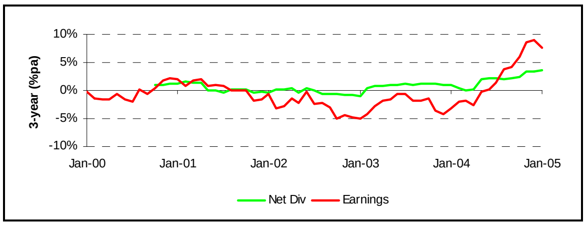
Predicted long-term inflation is now falling away from its peak at 3% pa – this may show the "risk premium" disappearing.

## 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

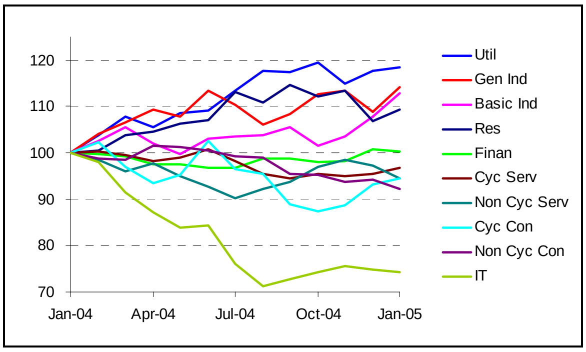



*Sources: Financial Times, Jagger & Associates*

## UK Equity Sector Returns

### Figure 4a: Sectors relative to All Share

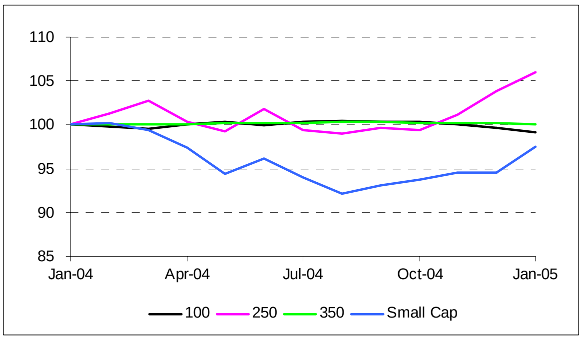



*Note:* *Relative lines' labels for sectors are in end value order for ease of use*

| (% absolute return) | 1 mth | 3 mth | 12 mth |
|---|---|---|---|
| Resources | 3.6 | 4.0 | 26.1 |
| Basic Industries | 6.1 | 18.6 | 30.2 |
| Gen Industrials | 6.1 | 8.2 | 31.5 |
| Cycl. Cons. Goods | 2.7 | 15.2 | 8.8 |
| Non-Cycl. Cons Goods | -1.0 | 3.3 | 6.2 |
| Cyclical Services | 2.6 | 8.3 | 11.6 |
| Non-Cyclical Services | -1.7 | 3.8 | 8.9 |
| Utilities | 2.0 | 5.8 | 36.6 |
| Information Technology | 0.8 | 6.9 | -14.3 |
| Non Financials | 1.5 | 5.8 | 15.2 |
| Financials | 0.8 | 9.3 | 15.7 |
| All-Share | 1.3 | 6.8 | 15.3 |

## UK Equity Size Returns

### Figure 4b: Size groups relative to All Share




Both the FTSE100 and the FTSE350 stay close to 100, as is expected given their weightings in the All Share index. Mid-caps had a good relative return in the final quarter of 2004.

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

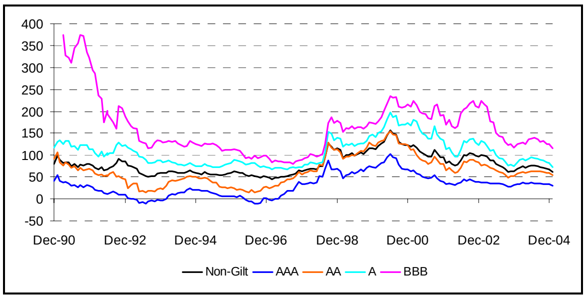
### MFR / Valuation Inconsistencies

As of September 2004, the "missing return" chart was dropped, because the effect of the equity-backed liabilities growing at a different rate to the matching assets has reduced significantly, but it is still available on e-mail request.

# FRS17 volatility and Corporate Bond market information

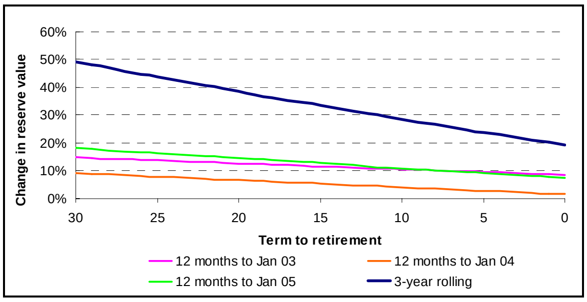
## Figure 5a: Credit Margin

**Basis points (units of 0.01%) relative to gilts**




## Figure 5b: 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 approx 13% over the last 12 months, and by 33% over the last three years, which is 10% per annum.

*Table 2a uses **semi-annual** yields. Table 2c includes Gilt irredeemables under the > 15 Yrs category for simplicity. Totals may differ from sums of entries due to rounding.*
*Sources: Barclays Capital (ex Fig 5b), Jagger & Associates*

## Bond Market Issuance and Coverage

- £2.25bn of 4¾% 2038 (1.95x, yield 4.49%, prev. Dec 04),
- £3bn of 4¾% 2010 (1.61x, yield 4.53%, prev. Nov 04), and
- £0.625bn of 2% IL 2035 (2.99x, real yield 1.47%, prev. Nov 04).

- Issuance data from iBoxx shows 12 new issues (in addition to further funding of existing bonds), with most being UK financial issuers, and 3 bonds reaching 1 year (or less) to maturity. There were no significant defaults, and only one moderate-sized apparent early redemption this month.

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

| Month End | AA rated Yield (%) | Gilt Yield (%) | Credit Margin (%) |
|---|---|---|---|
| Aug 2004 | 5.43 | 4.71 | 0.72 |
| Sep 2004 | 5.38 | 4.67 | 0.71 |
| Oct 2004 | 5.30 | 4.60 | 0.70 |
| Nov 2004 | 5.17 | 4.49 | 0.68 |
| Dec 2004 | 5.16 | 4.49 | 0.67 |
| Jan 2005 | 5.13 | 4.53 | **0.60** |

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

| Category | Mkt Val (£bn @ 31 Jan 05 & 04, 03) | | | Weight (%) |
|---|---|---|---|---|
| Gilts | 268 | 236 | 221 | 44.7 |
| Non Gilts | 331 | 283 | 259 | 55.3 |
| AAA | 125 | 101 | 99 | 20.9 |
| AA | 49 | 37 | 35 | 8.1 |
| A | 99 | 92 | 79 | 16.5 |
| BBB | 53 | 47 | 38 | 8.9 |
| Not rated | 5 | 6 | 8 | 0.8 |

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

| Category | Mkt Val (£bn @ 31 Jan 05 & 04) | | W't (%) | Dur'n (yrs) |
|---|---|---|---|---|
| Gilts | 268 | 236 | 44.7 | 8.1 |
| < 5 Yrs | 86 | 66 | 14.3 | 2.8 |
| 5 – 15 Yrs | 90 | 98 | 15.1 | 6.9 |
| > 15 Yrs | 92 | 72 | 15.4 | 14.1 |
| Non Gilts | 331 | 283 | 55.3 | 8.3 |
| < 5 Yrs | 86 | 56 | 14.4 | 2.9 |
| 5 – 15 Yrs | 115 | 108 | 19.2 | 7.3 |
| > 15 Yrs | 130 | 119 | 21.6 | 12.9 |

**Table 2d: Breakdown of Index-Linked Market**

| Category | Mkt Val (£bn @ 31 Jan 05) and number of issues | | W't (%) | Dur'n (yrs) |
|---|---|---|---|---|
| Gilts | 96 | (9) | 90.3 | 11.0 |
| < 5 Yrs | 13 | (2) | 12.3 | 3.0 |
| 5 – 15 Yrs | 42 | (3) | 39.2 | 8.2 |
| > 15 Yrs | 41 | (4) | 38.8 | 16.5 |
| Non Gilts | 10 | (46) | 9.7 | 15.0 |

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**Contact:** Simon Jagger, Jagger & Associates, 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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