JAGGER & ASSOCIATES

Investment Update
February 2005

Investment Headlines & Comment

- At the end of 2003, **Deutsche** were the 4th largest UK pension fund manager, with 2 index-trackers ahead of them. Now they are apparently up for a firesale. You have to wonder how so much has changed so quickly.
- **France** stole the long-dated limelight this month with €6bn of a 50-year bond. Meanwhile **Barclays Capital**'s Equity-Gilt study asked if long bonds were being bought at any price … which is old news for *Update* readers!
- **Britannic** have a new European high-alpha joint venture with some fund managers from **Neptune**, a 'satellite' / high conviction manager. It may be a way for 'small firms' to exist off larger parents, which could catch on?

Feature Section

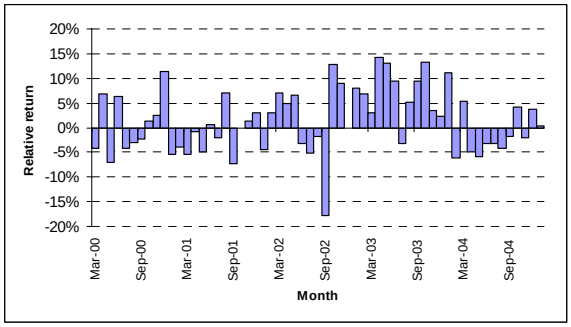
This month, given the seemingly relentless shift of schemes towards ultra-specialist investment mandates, each drawn across relatively few asset classes, replacing conventional multi-asset mandates (which would include traditional 'balanced' mandates), we thought some background on tactical asset allocation (TAA) was in order. The Editor reports.

Traditionally asset allocation is implemented by physical transactions in a scheme's affected asset classes, which is tricky if you have several separate managers operating in relatively distinct areas. So, many schemes do not even try to do it, let alone to its full potential. Although allowing an equity manager to make choices within equity markets, and a bond manager to choose within bond markets, they tend to leave the equity-bond split in line with their strategic aim, and thus miss a potentially valuable source of returns. An alternative route is to separate off the TAA and to do it entirely through an "overlay" of derivatives holdings (principally futures), thereby reducing the cost of implementation of decisions, avoiding disturbing the underlying scheme portfolio, and allowing additional asset allocation positions to be held. For example, suppose a scheme benchmark has only 10% in US Equities. It would be limited to underweighting its US Dollar exposure to that 10% (by holding none, or hedging what it did have) but the TAA product can allow a greater underweighting where the manager believes it to be appropriate, say 15% or 20%, and can allow underweighting in assets not held in a scheme's strategy.

This alternative structure is achieved by investing a small part of a portfolio in a TAA fund (say 3%), with the remaining fund (say 97%) in the conventional holdings, the latter usually being managed only for stock selection, not for asset allocation as well. This gives the same strategy structure as at present, but with perceived enhancements as outlined above. In setting up the alternative structure, it is important to be aware of what risk controls a TAA manager places on the size of positions that can be taken. Managers offering TAA are generally those backed by large banking institutions.

TAA results usually stem from decisions in country / region selection (for each of the equity and bond markets), and currency selection. Other lesser contributors will include the timing of decisions, and market capitalisation (e.g. deciding to overweight Small Cap stocks in a particular market, which is a separate decision to that of whether to over- or underweight the market as a whole). Interestingly, performance tends to be measured on a monthly basis, rather than quarterly, with excess return charts (similar to those we use in our performance reports) being used to convey the pattern of results emerging – Figure 1 gives an anonymous 'current' example. Fees often involve a performance-related element, and will appear high in the TAA portfolio, but more reasonable as a proportion of the overall scheme assets.

Figure 1: Example TAA performance record



TAA funds generally benchmark either the return on cash investments or an inflation measure, but it is also possible to find them with equity market benchmarks as well. Their target outperformance levels and variability of return will seem high (for example, to add 20% pa and have 25% pa tracking error) but when scaled back for the low weighting that gets put into the fund, you get back to the moderate outperformance being targeted under the current asset allocation route (for example, if a 3% allocation is used, then in this example, that gets back to an outperformance target of 0.6% pa at the overall portfolio level).

TAA as a concept has been around for a long time, but it never quite took off in the early 1990s, principally because there was little evidence then for even specialist managers to be any good at it. However, with schemes looking to improve their asset allocation implementation, and with hedge funds gaining in profile (of which a TAA fund is effectively an example), TAA products are making something of a comeback.

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 28 February 2005

Asset Class	1 month (%)	3 months (%)	12 months (%)	3 years (% p.a.)	5 years (% p.a.)	10 years (% p.a.)
UK Equities	2.6	7.0	15.0	3.7	-0.7	8.7
Overseas Equities	1.2	4.3	8.6	-1.1	-4.1	6.4
US Equities	0.0	2.4	**3.2**	**-5.6**	-5.1	8.9
Europe ex UK Equities	3.1	6.9	16.4	4.6	-2.3	9.3
Japan Equities	-0.1	4.3	9.9	3.2	**-8.5**	**-2.8**
Pacific ex Japan Equities	3.5	9.1	15.6	8.8	3.4	2.5
Emerging Markets	**6.6**	**13.8**	**22.5**	12.3	2.0	3.6
UK Long-dated Gilts	-0.1	0.0	6.8	5.8	4.9	9.8
UK **Long-dated** Corp. Bonds	0.6	1.9	9.3	7.8	8.3	-
UK Index-Linked Gilts	-0.3	0.6	6.5	7.3	5.4	8.0
Overseas Bonds	**-2.1**	**-0.3**	4.2	3.2	4.8	4.8
Property *	0.9	4.5	19.0	**13.6**	**11.6**	**11.3**
Cash	0.4	1.2	4.8	4.2	4.7	5.7
Hedge Funds original $ basis *	-0.2	4.3	6.7	8.5	6.9	12.6
Illustrative £-converted version *	1.7	1.7	3.1	-1.5	3.8	10.7
Euro relative to Sterling	-0.3	-0.9	3.0	4.0	2.5	-
US $ relative to Sterling	-2.0	-0.5	-3.4	-9.7	-3.9	-1.9
Price Inflation (RPI) *	-0.5	0.2	3.2	2.9	2.5	2.6
Price Inflation (CPI) *	-0.5	0.2	1.6	1.5	1.4	1.6
Price Inflation (RPIX) *	-0.6	0.1	2.1	2.4	2.3	2.5
Earnings Inflation **	2.9	4.1	4.3	3.5	3.6	4.0
All Share Capital Growth	2.2	6.4	11.2	0.4	-3.5	5.3
Net Dividend Growth	2.6	3.0	9.4	3.7	2.8	-
Earnings Growth	4.8	1.4	28.2	12.1	6.7	5.4

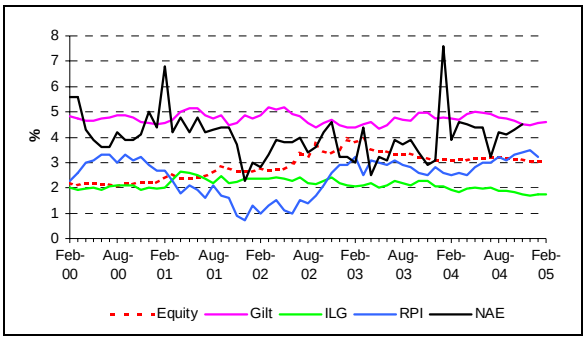
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- *UK Equities (incl. dividends and earnings) – FT-A All Share.*
- *Overseas Equities (incl. regions) – blend of FT All-World / World 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.*

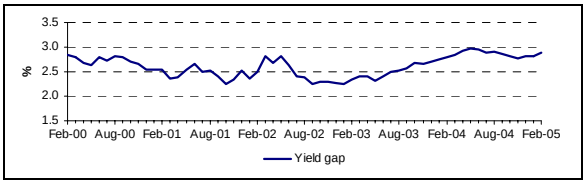
- Several equity regions fared well this month, but currency returns were negative. UK Equity earnings growth was high. Property has been overtaken by Emerging Markets for the best 12-month return.

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.



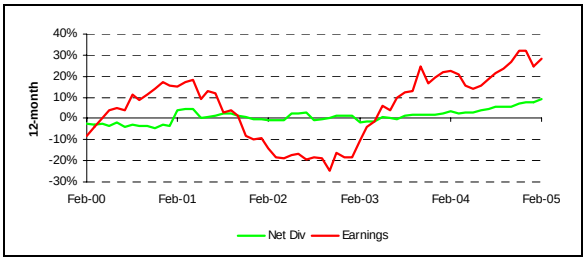
Sources: Financial Times, Office for National Statistics, Jagger & Associates

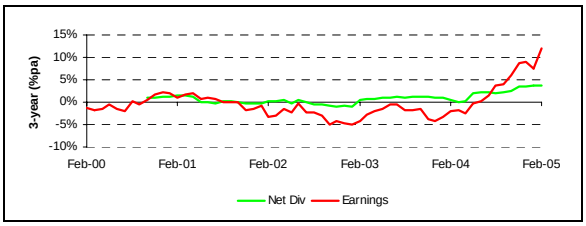
Predicted long-term inflation is creeping back to its peak at 3% pa – this may show the "risk premium" reappearing.

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

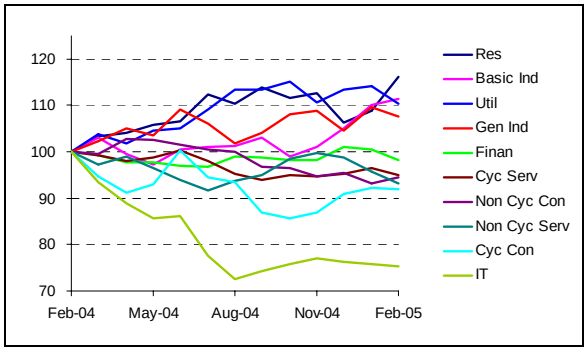




Sources:Financial Times, Jagger & Associates

UK Equity Sector Returns

Figure 4a: Sectors relative to All Share

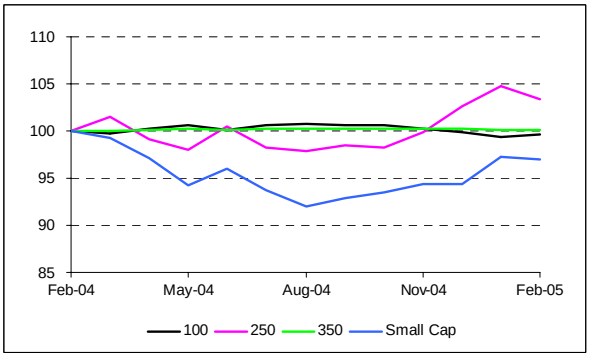


Note: Relative lines' labels for sectors are in end value order for ease of use

(% absolute return)	1 mth	3 mth	12 mth
Resources	9.5	10.2	33.6
Basic Industries	3.8	17.9	28.1
Gen Industrials	0.8	5.7	23.8
Cycl. Cons. Goods	2.2	13.3	5.8
Non-Cycl. Cons Goods	4.1	6.7	8.8
Cyclical Services	1.0	7.3	9.2
Non-Cyclical Services	-0.1	-0.2	7.2
Utilities	-0.8	6.7	26.9
Information Technology	2.0	4.8	-13.2
Non Financials	3.6	7.1	15.8
Financials	0.2	6.7	12.9
All-Share	2.6	7.0	15.0

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

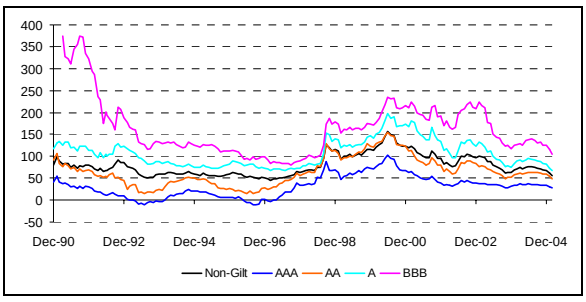
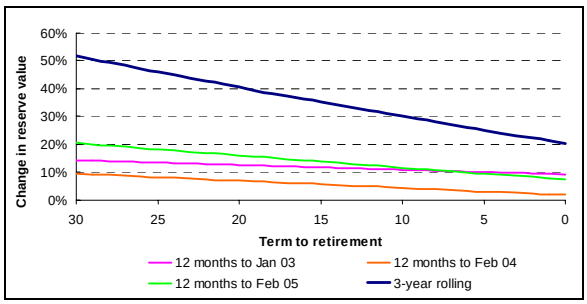


Figure 5b: FRS17 volatility indicator

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 14% over the last 12 months, and by 35% over the last three years, which is 11% 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

- £2.75bn of 4¾% 2010 (1.3x, yield 4.76%, prev. Jan 05), and
- £0.375bn of 2½% IL 2013 (3.0x, real yield 1.8%, prev. July 04). High coverage for even a fairly short IL stock.

- Issuance data from iBoxx shows 19 new issues (in addition to further funding of existing bonds), with only 5 being clear UK issuers, and 1 bond reaching 1 year (or less) to maturity. There were no significant defaults, and only 2 moderate-sized apparent early redemption this month.

Table 2a: Trends in Long-dated AA Margins

Month End	AA rated Yield (%)	Gilt Yield (%)	Credit Margin (%)
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
Feb 2005	5.12	4.56	**0.56**

Table 2b: Breakdown of Market Size

Category	Mkt Val (£bn @ 28 Feb 05 & 04, 03)			Weight (%)
Gilts	270	240	225	44.5
Non Gilts	336	288	262	55.5
AAA	128	104	101	21.1
AA	50	37	34	8.3
A	99	92	79	16.4
BBB	54	48	40	8.8
Not rated	5	6	8	0.8

Table 2c: Breakdown of Market Maturity

Category	Mkt Val (£bn @ 28 Feb 05 & 04)		W't (%)	Dur'n (yrs)
Gilts	270	240	44.5	8.0
< 5 Yrs	85	66	14.1	2.7
5 – 15 Yrs	92	98	15.2	6.8
> 15 Yrs	92	76	15.2	14.1
Non Gilts	336	288	55.5	8.3
< 5 Yrs	90	58	14.8	2.9
5 – 15 Yrs	118	111	19.4	7.3
> 15 Yrs	129	118	21.3	12.9

Table 2d: Breakdown of Index-Linked Market

Category	Mkt Val (£bn @ 28 Feb 05) and number of issues		W't (%)	Dur'n (yrs)
Gilts	96	9	90.3	11.0
< 5 Yrs	13	2	12.3	2.9
5 – 15 Yrs	42	3	39.4	8.2
> 15 Yrs	41	4	38.6	16.4
Non Gilts	10	46	9.7	15.0

JAGGER & ASSOCIATES

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

See our website for details of investment consultancy services we provide to actuarial firms, pension funds and charities.