



Investment Update October 2008

Investment Headlines & Comment

- A further month of **volatility**, in actual markets and derivatives forecasts. **Credit spreads** have also moved out even further.
- Major **gilt issuance** this month, with most of it maturing in the next 10 years. Increased **downgrades** from A to BBB.
- Double-digit currency movements as some investors have been forced to close out trades, back into US and Japanese cash.

Feature Section

Rather than focus on a single topic this month, we thought readers might appreciate a satellite overview of some of the remarkable financial movements that have unfolded over the last few weeks. Whilst some commentators had been pessimistic about the world's financial health for some time before the 'credit crunch' really kicked in, we doubt anyone came close even 6 months ago to predicting the way and the severity of how events would unfold.

Figure 1a: Currency movements

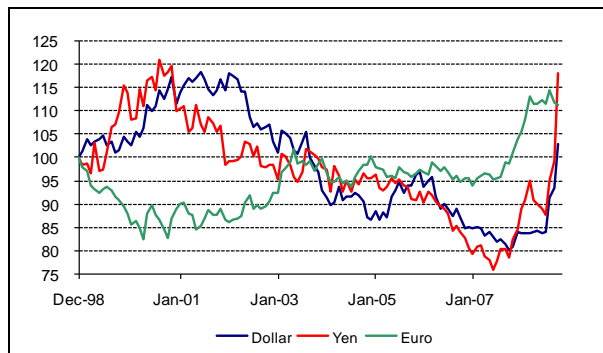
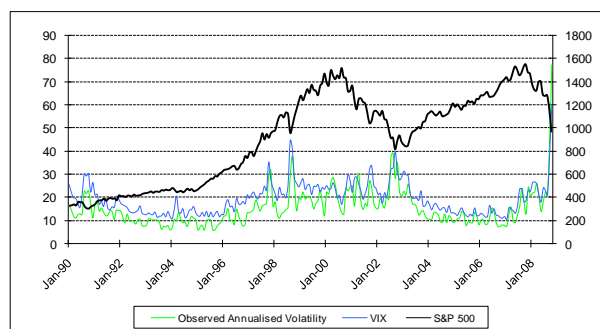


Figure 1a shows the movements in currencies (last discussed in our July 2003 issue). Currency forwards are suggesting little expected future movement in most regions over the next year, although (as a brief aside, Sterling is expected to strengthen against Turkey, Russia and especially Argentina.)

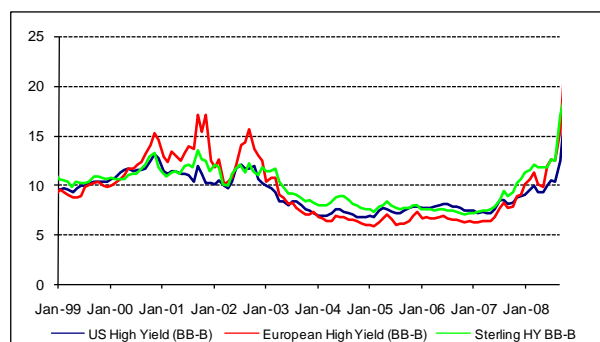
Hedge funds are facing their worst consecutive 4 month-by-month returns since the relevant HFR indices began, and the costs of unwinding the leverage into the relevant currencies that funded it is going to be a significant factor in this.

Figure 1b: Volatility measures



The left-hand scale of Figure 1b shows the movements in month-end historic volatility and expected future volatility for the US Equity market (last shown in our July 2007 issue). Intra-month spikes have also occurred so Figure 1b if anything understates the 'fear' that is priced in equity market options. The right-hand scale of Figure 1b shows that the recent S&P 500 losses have taken it back to levels close to its low point in the run-up to the second Iraq war, and seen before then in 1998 before the tech boom kicked in. The US election may give some element of bounce-back, but it would be a brave soul that said that rally would be sustained.

Figure 1c: Yields on BB and B rated bonds



Our monthly data on page 4 has shown just how strongly sentiment has moved against investment-grade credit in recent months, with margins over gilts now at levels not seen since the relevant indices began – markets are thus anticipating very high default rates, which some believe may give a buying opportunity for those who think the pessimism is overdone.

Figure 1c shows the movements in yields for BB and B rated bonds (last shown in our March 2007 issue). These bonds are generally shorter-dated than those in the investment grade area, and for them to be offering yields out at 15% or so above government bonds again gives a huge buying opportunity for those who think the pessimism is overdone. But that size of credit margin begs the question of where the line is drawn between investment and speculation ...

Sources: FT, CBOE, MLX



Asset Class Returns

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 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 October 2008

Asset Class	1 month (%)	3 months (%)	12 months (%)	3 years (% p.a.)	5 years (% p.a.)	10 years (% p.a.)
UK Equities	-11.9	-19.7	-34.4	-3.2	3.9	1.7
Overseas Equities	-11.7	-15.5	-26.4	-1.2	3.9	2.4
US Equities	-8.5	-5.8	-17.5	-2.0	1.7	0.9
Europe ex UK Equities	-15.5	-24.4	-33.9	0.2	7.2	3.1
Japan Equities	-5.7	-10.4	-18.6	-6.0	1.2	1.6
Pacific ex Japan Equities	-16.9	-27.9	-44.3	2.6	7.8	7.1
Emerging Markets	-20.0	-32.4	-43.7	3.0	10.9	10.8
UK Long-dated Gilts	-0.7	0.3	3.4	2.1	4.8	4.6
UK Long-dated Corp. Bonds	-4.5	-8.3	-11.0	-3.2	1.6	4.4
UK Over 5 Yrs Index-Linked Gilts	-7.9	-8.5	0.6	3.3	5.7	5.4
High Yield (Global)	-8.8	-8.1	-7.8	-1.8	1.4	3.2
Overseas Bonds	9.4	18.8	34.5	9.3	6.3	5.3
Property *	-2.4	-4.8	-18.1	2.0	7.7	9.0
Cash	0.5	1.5	6.1	5.6	5.2	5.1
Commodities £-converted	-20.9	-28.5	-5.1	-4.0	6.5	9.4
Hedge Funds original \$ basis *	-5.8	-9.3	-9.5	4.3	6.9	9.3
Illustrative £-converted version *	-3.6	1.4	4.0	4.0	5.5	8.8
Euro relative to Sterling	-0.4	-0.3	12.7	5.1	2.8	-
US \$ relative to Sterling	10.1	22.5	28.6	3.0	0.9	0.4
Price Inflation (RPI) *	0.6	0.7	5.0	4.2	3.7	2.9
Price Inflation (CPI) *	0.5	1.2	5.2	3.1	2.6	1.9
Price Inflation (RPIX) *	0.6	0.7	5.5	3.8	3.2	2.7
Earnings Inflation **	-1.1	-0.2	3.2	3.7	3.8	3.9
All Share Capital Growth	-12.1	-20.6	-36.8	-6.4	0.5	-1.4
Net Dividend Growth	0.5	-1.7	19.4	11.8	11.0	5.6
Earnings Growth	3.2	-3.0	-8.5	9.6	15.2	6.7

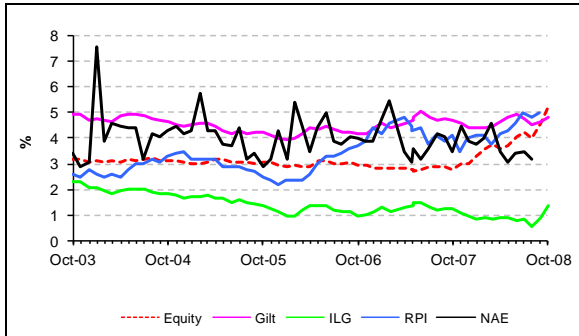
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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 Over 5 Years)
- UK Corporate Bonds – Barclays Capital Non-Gilt Over 15 Year index (all credit ratings combined)
- High Yield – Merrill Lynch Global, £ Unhedged
- Overseas Bonds – JP Morgan Traded Unhedged World ex UK
- Property – IPD Monthly 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 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.

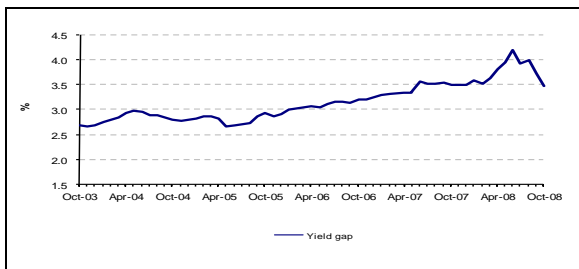


Yields and Yield Gaps

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.

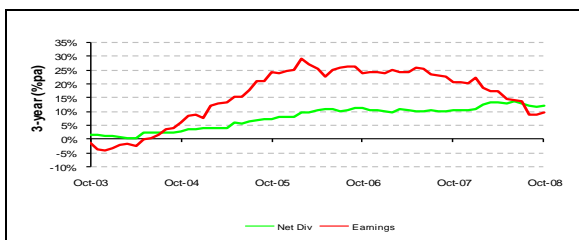
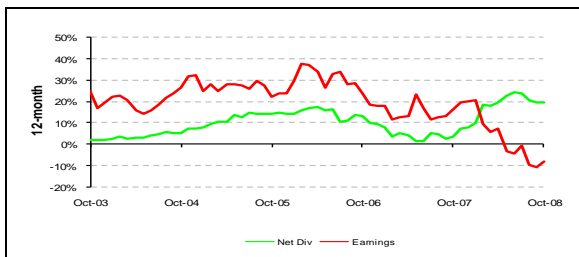


The gap has dropped back from the 4% level, but is still suggesting expectations of prolonged higher longer-term inflation + risk premium for conventional bonds, relative to index-linked.

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]

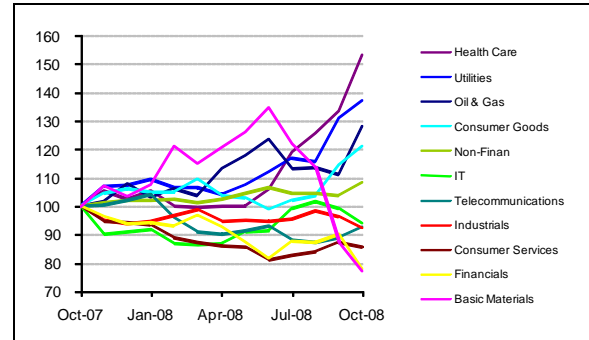
Figure 3: Dividend & Earnings Growth



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

UK Equity Sector Returns

Figure 4a: Sectors relative to All Share



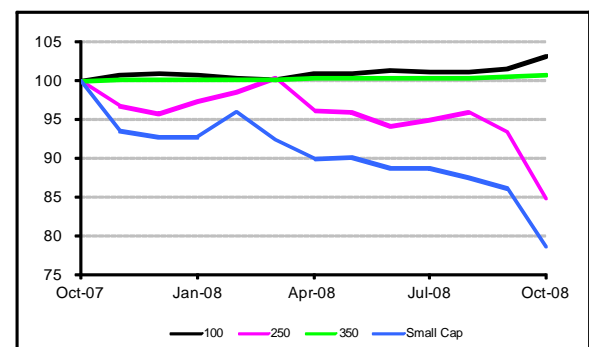
Note: Relative lines' labels for sectors in end-value order

Basic Materials have fallen back *very* sharply this month.

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	1.8	-9.0	-15.7
Basic Materials	-22.3	-49.3	-49.4
Industrials	-15.7	-22.4	-39.3
Consumer Goods	-7.0	-4.9	-20.4
Health Care	1.2	3.4	0.6
Consumer Services	-13.2	-16.7	-43.6
Telecommunications	-8.3	-15.6	-39.1
Utilities	-7.8	-5.9	-9.9
Non-Finan	-7.8	-16.7	-28.8
Financials	-23.8	-28.8	-48.8
IT	-16.8	-24.1	-38.4
All Share	-11.9	-19.7	-34.4

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Small and Mid Cap suffered heavily this month.

FRS17 volatility indicator

Now discontinued, but available on request.



Bond market information

Figure 5: £ Non-Gilt Credit Margins

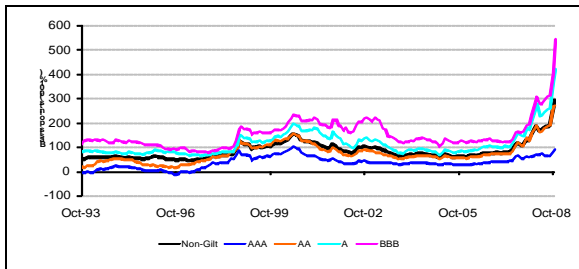


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA (%)	FT 20 yr Gilt Yield (%)	Margin (%)
May 08	6.45	4.86	1.59
Jun 08	6.63	4.98	1.65
Jul 08	6.51	4.76	1.75
Aug 08	6.33	4.55	1.78
Sep 08	7.17	4.65	2.52
Oct 08	7.42	4.83	2.59

Tables 2b, 2c: £ Market Size and Maturity

Category	Mkt Val (£bn @ Oct 08 & 06, 04)			Weight (%)
Gilts (29)	446	320	262	52.8
Non Gilts (1,116)	399	407	320	47.2
AAA (236)	149	152	122	17.6
AA (238)	70	64	44	8.3
A (394)	119	124	95	14.1
BBB (234)	58	64	54	6.9
Not rated (14)	2	3	5	0.3

Category	Mkt Val (£bn @ Oct 08, 06)		W't (%)	Dur'n (yrs)
Gilts (29)	446	320	52.8	9.0
< 5 Yrs (9)	131	93	15.5	2.6
5-15 Yrs (9)	142	115	16.8	7.0
> 15 Yrs (11)	173	111	20.5	15.3
Non Gilts (1,116)	399	407	47.2	6.6
< 5 Yrs (338)	140	111	16.5	2.4
5-15 Yrs (470)	149	161	17.7	6.7
> 15 Yrs (308)	111	135	13.0	11.7

£ Gilt Market Issuance and Coverage

- £2.25bn of 4¼% 2049 (2.08x, yield 4.54%, prev Sep 08)
- £3.75bn of 4½% 2013 (2.10x, 4.42%, Sep 08)
- £4.75bn of 4¼% 2011 (2.29x, 3.85%, Nov 06)
- £3.0bn of 5% 2018 (2.01x, 4.47%, July 08)
- £4.0bn of 4% 2016 (1.61x, 4.28%, Feb 07)
- £1.2bn of ILG 1¾% 2022 (1.12x, r.y. 1.88%, Jun 08)
- £1.0bn of ILG 1¼% 2032 (2.49x, r.y. 1.27%, new)

Tables 2d, 2e: € Market Size and Maturity (Oct 08)

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (241)	3,215	60.0
Non Sovereigns	2,144	40.0
AAA (628)	1,104	20.6
AA (417)	471	8.8
A (534)	401	7.5
BBB (237)	168	3.1

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (592)	1,518	28.3
3 – 5 Yrs (501)	1,188	22.2
5 – 7 Yrs (365)	753	14.1
7 – 10 Yrs (395)	937	17.5
10+ Yrs (204)	965	18.0

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Oct 08 & 06)		W't (%)	Dur'n (yrs)
Gilts (13)	159	132	90.9	13.2
< 5 Yrs (2)	32	21	18.3	3.7
5 – 15 Yrs (4)	54	61	30.9	8.9
> 15 Yrs (7)	73	50	41.7	20.7
Non Gilts (56)	16	13	9.1	15.1

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

Month End	US (%)	Euro (%)	Sterling (%)
Jun 08	10.01	11.86	11.83
Jul 08	10.51	12.54	12.64
Aug 08	10.41	12.45	12.57
Sep 08	12.55	15.55	17.16
Oct 08	16.83	21.72	18.89

Sources: Barclays Capital, DMO, iBoxx, J&A, MLX

