J<u>AGGER</u> & A<u>SSOCIATES</u>

Investment Update
February 2008

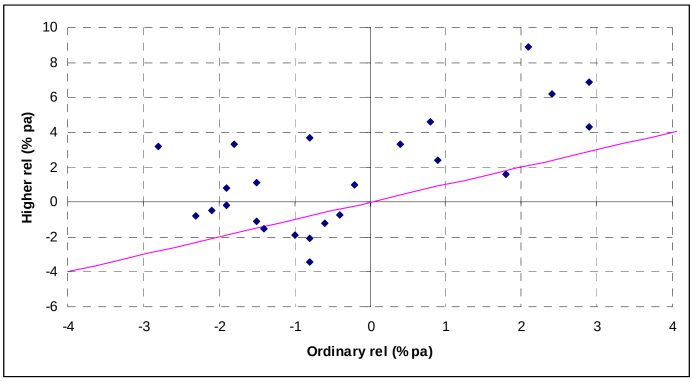
Investment Headlines & Comment

- **Corporate bond yields** have continued to widen (see page 4), and unless an investor expects major defaults, it could be a strong opportunity for buyers.
- Widening **credit margins** on financials have been the major factor – there is now a far greater margin offered on fixed corporate, relative to index-linked corporate.
- **Commodities** had a remarkable month – unlike previous months, it was not confined to the energy sector, because demand for some agricultural markets has surged.

Feature Section

A fashionable marketing area is 130/30 investing – going more than 100% into stocks you like, and financing this by going "short" in stocks you dislike. It sounds great in principle – after all, why stop building portfolios just by using things you like (which is effectively a 100/0 approach). Readers will know of the Editor's occasional jaundice on buzz-ideas, and over the next two months we will investigate the 130/30 area. This month we consider the past case for managers increasing the risk-appetite for their portfolios, and the skills going short would require of a manager. Next month, we model the statistical consequences of proceeding in that way.

Figure 1: UK Equity manager results



Source: CAPS Note: we have not counted "[High] Income" as specialist

Over the last 3 and 5 years (to December 2007), only 40% of pooled UK Equity funds have outperformed the All Share Index net of fees, which has partly fuelled the growth in index-tracking mandates. In the past, some managers have claimed that it is the risk-control element of their "ordinary" portfolios that drags them down, and that a less-constrained approach would see them do better. Figure 1a shows the annualized 3-year relative returns achieved by UK Equity managers in the CAPS pooled universe, for those 24 managers with both "conventional" and "specialist" funds. Almost 60% of the "specialist" funds in this restricted dataset delivered outperformance versus the index (although whether this would be sustained over a less benign period for equities is another matter outside the scope of this note). Interestingly, there is some evidence that the returns on specialist UK Equity funds are better than those on their lower-alpha equivalents, because over two thirds of the plot points are above the "diagonal" (although some of these plot points still relate to underperformance on both funds!). On that measure, the managers' marketing claims may have had some justification after all. However, only a third of the managers delivered outperformance on both their "conventional" and "specialist" funds (a somewhat lower percentage than the 40% outperforming across the whole set of funds), and more than a third did not deliver outperformance on either fund.

As an aside, the top left quadrant is intriguing – the six managers who underperformed on their "conventional" product and yet outperformed on their "specialist" funds. (Note that this represents a minority from within those underperforming on "conventional" funds.) It could just be a coincidence, but five of the six are major insurance companies (or asset management firms inextricably associated with them).

A long-only portfolio can be thought of as "index portfolio + liked portfolio – disliked portfolio", where the extent of the "dislike" is limited to the index weighting. The "liked portfolio" is where most managers expend most effort, and Figure 1 suggests this is rewarded in some cases. For many managers, the "disliked portfolio" is simply identified through high-level screening out of companies that they feel are not going to be of interest (even for "risk control), and the index weights are often small. For those unloved companies, it would be dubious if they became a material part of a shorting portfolio without more research. Some managers feel they would struggle to quantify how badly a company was going to do (as opposed to how well), although this approach has been a key part of several hedge funds' operations. The key seems to be the approach adopted on the companies that have a larger weight in the index – a few major underweightings here can swamp an army of tiddly positions, and once the limit on underweighting is removed to allow shorting, things could get interesting (or just downright scary) ….

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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 29 February 2008

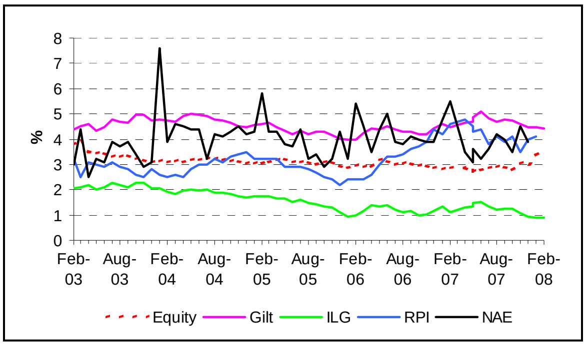
Asset Class	1 month (%)	3 months (%)	12 months (%)	3 years (% p.a.)	5 years (% p.a.)	10 years (% p.a.)
UK Equities	0.8	-7.7	-2.7	9.9	15.1	4.2
Overseas Equities	0.2	-5.7	2.2	10.7	12.8	4.6
US Equities	**-3.3**	-6.5	-4.8	4.8	6.9	2.2
Europe ex UK Equities	2.4	-7.3	5.5	15.9	20.0	7.0
Japan Equities	0.4	-4.6	**-13.6**	5.5	9.4	**1.8**
Pacific ex Japan Equities	4.5	-5.9	25.6	23.7	25.0	10.1
Emerging Markets	**7.6**	-2.2	**31.9**	**27.6**	**30.4**	**12.0**
UK Long-dated Gilts	-0.3	2.4	2.4	4.7	4.2	6.2
UK Long-dated Corp. Bonds	-2.6	-2.1	-5.5	**1.7**	3.7	6.4
UK Over 5 Yrs Index-Linked Gilts	0.0	3.8	9.8	7.7	7.0	7.3
High Yield (Global)	-0.9	0.9	-3.3	3.5	5.1	3.4
Overseas Bonds	2.5	**9.7**	15.4	4.5	**2.4**	4.6
Property *	-1.6	**-8.6**	-7.6	9.0	11.3	11.0
Cash	0.5	1.5	6.2	5.3	4.9	5.2
Commodities £-converted	11.4	21.9	42.9	10.3	7.6	9.4
Hedge Funds original $ basis *	-2.5	-4.1	6.1	9.9	11.4	9.7
Illustrative £-converted version *	-2.8	0.2	4.8	7.9	7.3	7.6
Euro relative to Sterling	2.5	6.9	13.3	3.5	2.2	-
US $ relative to Sterling	0.2	3.6	-1.3	-1.1	-4.5	-1.9
Price Inflation (RPI) *	-0.5	0.4	4.1	3.6	3.3	2.8
Price Inflation (CPI) *	-0.7	0.2	2.2	2.3	2.0	1.6
Price Inflation (RPIX) *	-0.4	0.5	3.4	3.1	2.7	2.5
Earnings Inflation **	3.2	4.3	3.9	4.0	3.8	4.0
All Share Capital Growth	0.4	-8.2	-5.8	6.5	11.4	1.2
Net Dividend Growth	8.0	8.9	18.8	12.6	10.1	5.2
Earnings Growth	-3.9	-2.8	9.5	18.9	21.4	7.6

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

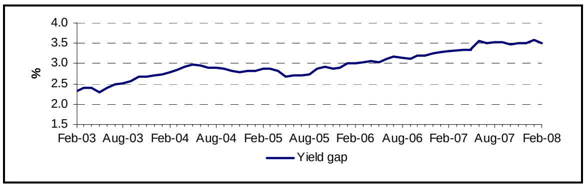
- *UK Equities (incl. dividends and earnings) – FT-A All Share.*
- *Overseas Equities (incl. regions) – blend of FT All-World / World subindices*
- *Emerging Markets from MSCI US $ based total return index (overall Index to 31 Oct 2001, Free Index from 1 Nov 2001 to take account of foreign investment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

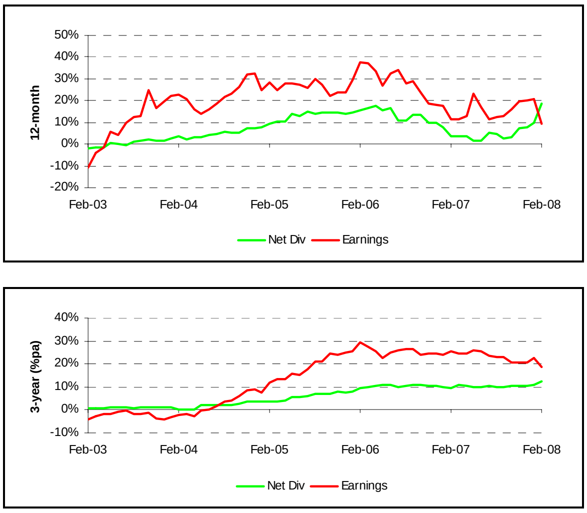


The gap is staying at the 3.5% level, suggesting expectations of higher longer-term inflation as well as an increased risk premium for conventional bonds, relative to index-linked.

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*]

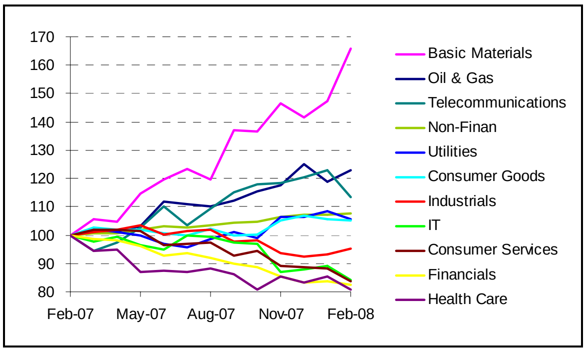
Figure 3: Dividend & Earnings Growth



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



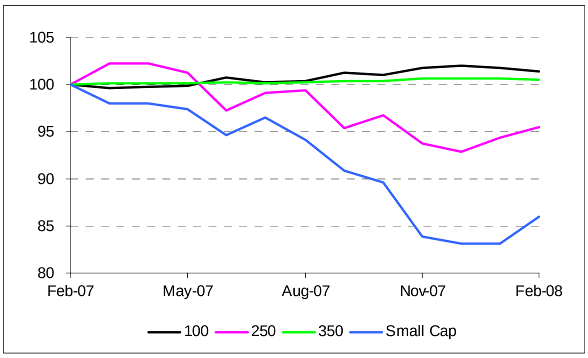
Note: Relative lines' labels for sectors in end-value order

Basic Materials were strongest over the last 12 months by a very large margin.

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	4.2	-3.3	19.8
Basic Materials	13.5	4.4	61.3
Industrials	2.8	-6.3	-7.4
Consumer Goods	0.6	-7.5	2.6
Health Care	-4.4	-12.5	-21.2
Consumer Services	-4.2	-13.2	-18.4
Telecommunications	-7.2	-11.8	10.2
Utilities	-2.0	-8.2	2.8
Non-Finan	1.3	-6.6	4.9
Financials	-0.8	-10.9	-19.9
IT	-4.8	-11.1	-18.3
All Share	0.8	-7.7	-2.7

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Mid and Small Cap rallied slightly in relative terms.

FRS17 volatility indicator

A scheme whose actives on average now have 15 years to retirement will have seen their FRS17 liability value change by approx 16% over the last 12 months, and be static over the last three years, which is 0% per annum.

Bond market information

Figure 5: Credit Margins for last 15 Years

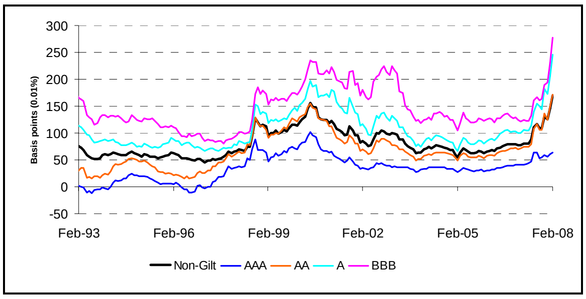


Table 2a: Trends in Long-dated AA Margins

Month End	AA rated Yield (%)	(Barclays) Gilt Yield (%)	Credit Margin (%)
Sep 07	5.69	4.62	1.07
Oct 07	5.63	4.58	1.05
Nov 07	5.80	4.50	1.30
Dec 07	5.58	4.34	1.24
Jan 08	5.85	4.37	1.48
Feb 08	**6.08**	4.42	**1.66**

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

Category	Mkt Val (£bn @ Feb 08 & 06, 04)			Weight (%)
Gilts (27)	352	301	240	46.0
Non Gilts (1,112)	414	379	288	54.0
AAA (283)	158	143	104	20.7
AA (202)	60	59	37	7.9
A (389)	128	116	92	16.7
BBB (224)	65	57	48	8.5
Not rated (14)	3	4	6	0.4

Category	Mkt Val (£bn @ Feb 08 & 06)		W't (%)	Dur'n (yrs)
Gilts (27)	352	301	46.0	9.3
< 5 Yrs (8)	96	87	12.5	2.5
5–15 Yrs (9)	117	93	15.3	7.3
> 15 Yrs (10)	139	120	18.1	15.6
Non Gilts (1,115)	414	379	54.0	7.2
< 5 Yrs (339)	136	106	17.7	2.7
5–15 Yrs (464)	158	138	20.6	7.1
> 15 Yrs (312)	120	136	15.7	12.4

£ Gilt Market Issuance and Coverage

- £2.5bn of 5% 2018 (1.91x, yield 4.50%, prev Nov 07)
- £2.0bn of 4½% 2042 (1.63x, yield 4.52%, Nov 07)
- £0.875bn of ILG $1^{1}/_{8}$% 2037 (2.05x, r.y. 0.97%, Oct 07)

- **iBoxx Sterling corporate:** 11 new sterling corporate issues (£2.8bn) from 9 issuers across the world, and aggregate net funding or redemption (+£3.0bn) by 22 (mostly non-UK) corporate or sub-sovereign issuers. 5 bonds redeemed early or eliminated. 3 bonds fell within 1 year of maturity.
- **iBoxx Euro:** New euro issues €43bn (including €18bn governments), and aggregate net funding or redemption (€37bn) of existing bonds (of which €36bn by governments). 28 bonds fell within 1 year of maturity. No early redemptions.

Tables 2d, 2e: € Market Size and Maturity

Category	Mkt Val (€bn @ Feb 08)	Weight (%)
Sovereigns (236)	3,215	60.5
Non Sovereigns	2,098	39.5
AAA (613)	1,111	20.9
AA (414)	445	8.4
A (450)	376	7.1
BBB (218)	166	3.1

Category	Mkt Val (€bn @ Feb 08)	Weight (%)
1 – 3 Yrs (471)	1,383	26.0
3 – 5 Yrs (467)	1,131	21.3
5 – 7 Yrs (371)	798	15.0
7 – 10 Yrs (402)	1,000	18.8
10+ Yrs (220)	1,002	18.9

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Feb 08 & 06)		W't (%)	Dur'n (yrs)
Gilts (14)	162	117	91.0	12.6
< 5 Yrs (2)	23	8	12.9	2.5
5 – 15 Yrs (5)	72	68	40.4	8.3
> 15 Yrs (7)	67	41	37.6	20.7
Non Gilts (56)	16	12	9.0	15.3

Sources: Barclays Capital, DMO, iBoxx, Jagger & Associates

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