JAGGER & ASSOCIATES

Investment Update
April 2008

Investment Headlines & Comment

- **Gilt issuance** by the back door this month – all £15bn of it – and a 'mortgages for gilts' package to help oil the inter-bank system, involving up to £50bn of gilts.
- **Credit margins** have thus started to come back down from their extremes, particularly in lower-rated bonds. Equity markets in general have rallied somewhat.
- The **dispersion** of managers' UK Equity returns is now incredibly high – CAPS shows that just the inter-quartile spread on 12-month UK Equity results is at over 7%.

Feature Section

Last month, in our 100th issue competition, we asked "has anything really changed in investment since *Update* issue 1, or has it just been re-packaged?" We received an interesting range of thoughts from our readers – here is a selection.

Keith Wallace of Reed Smith, who was a guest contributor to this column in May 2006, observed on "then and now" as follows: "Fear has now replaced greed, but you can still be blinded by both. Contesting theologies now divide those who believe they, or someone out there, can consistently beat the market and those who don't. Those who know the least are still the quickest to offer market timing advice. We now appreciate that strategies that make modest gains are neutralised by scaling-up and competitor duplication, and it is still the case that low-risk, well-controlled, techniques for exploiting pricing anomalies can wipe you out. Every set of risk controls is still stultified by the investment banks' kudos and bonus culture, but still no one gets promoted for avoiding risk."

Meanwhile, Derek Scott, a Trustee of Stagecoach, appears to have rediscovered treasures from the past. "Looking back to 1999, we'd seriously considered selling [equities] in May and not coming back until September's St Leger (9/11/99). Selling in May 1999 and not coming back until after the 9/11 in 2001 looks even better with hindsight. What's changed for me since is re-discovering Keynes and Adam Smith (whom Derek says undergraduates never read, despite one of [Derek's] double firsts being political economy), also re-discovering Ben Graham, whose security analysis was recommended to 1970s accountants; sadly, few took any notice.

Instead of index-relative mandates and the tyranny of such benchmarks, re-discovering investment as diversified return-seeking, long-term, long-only. Also, investment appraisal and performance measurement based on initial yields, forecast growth and good old-fashioned monitoring of realised and unrealised book gains and losses; instead of market-based fair values beloved by accounting standard-setters, intrinsic fair values based on fundamentals. Just re-packaging? Probably …. but it's investing, just not as we knew it."

Over in the world of investment management, Nick Spencer of Lehman Brothers was quite definite: "Investment principles have not changed - (1) diversify your sources of return for long term growth and (2) if you don't have a competitive advantage - don't compete. [**Ed.:** on that basis, we wouldn't have an England football team.]

However, reliance on traditional asset-liability techniques led to pension funds' heavy dependence on equity markets for excess returns – a risk which was largely hidden during the 20-year bull market to 2000. Since 2000, the nature of this equity reliance has been unmasked and funds face two key challenges: managing the size and volatility of the financial impact on sponsors: typically under-appreciated in the past; gaining access to a broader diversity of returns often whilst starting from a governance structure and perspective predicated on equity-only investment strategies.

Whilst the principles are unchanged, it is now far clearer that sustainable investment success requires funds to solve these challenges. Investment has not been re-packaged but hopefully strategy and implementation are being re-thought."

Owl glasses go to the three above (once we've figured out how to stop breaking them in transit). My thanks to all those who took the time to submit their thoughts, and an honorable mention must also go to Allan Martin FFA of ACMCA Ltd for submitting his observations in (just about) rhyming verse.

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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 30 April 2008

Asset Class	**1 month (%)**	**3 months (%)**	**12 months (%)**	**3 years (% p.a.)**	**5 years (% p.a.)**	**10 years (% p.a.)**
UK Equities	6.3	4.9	-4.3	12.6	14.1	4.1
Overseas Equities	5.9	4.8	2.4	13.8	12.4	4.7
US Equities	5.2	1.3	-3.4	7.4	6.3	**2.2**
Europe ex UK Equities	4.2	8.5	2.3	20.1	18.8	6.7
Japan Equities	7.7	4.2	-5.4	8.0	11.7	3.2
Pacific ex Japan Equities	8.4	7.0	20.9	26.8	25.3	11.4
Emerging Markets	**8.5**	**10.5**	**27.0**	**32.6**	**30.0**	**12.3**
UK Long-dated Gilts	-1.6	-1.6	4.3	3.5	4.3	5.7
UK Long-dated Corp. Bonds	1.0	-2.6	-3.0	**1.6**	3.6	6.0
UK Over 5 Yrs Index-Linked Gilts	-1.3	0.6	12.5	7.3	7.2	7.0
High Yield (Global)	4.4	3.5	1.2	6.1	4.6	3.9
Overseas Bonds	**-3.1**	2.7	16.6	4.2	**2.5**	4.8
Property *	-0.8	**-3.4**	**-10.7**	7.7	10.6	10.6
Cash	0.5	1.5	6.2	5.4	5.0	5.2
Commodities £-converted	8.3	19.2	51.6	13.4	14.3	10.6
Hedge Funds original $ basis *	-2.1	-3.3	3.5	9.2	11.1	9.0
Illustrative £-converted version *	-2.2	-3.6	2.1	7.4	6.2	7.1
Euro relative to Sterling	-1.4	5.6	15.2	5.2	2.4	-
US $ relative to Sterling	0.4	0.4	1.0	-1.2	-4.2	-1.7
Price Inflation (RPI) *	0.3	0.6	3.8	3.6	3.3	2.8
Price Inflation (CPI) *	0.4	0.5	2.4	2.4	2.1	1.7
Price Inflation (RPIX) *	0.5	0.9	3.5	3.2	2.8	2.6
Earnings Inflation **	4.3	10.8	4.0	4.9	4.9	4.7
All Share Capital Growth	5.9	3.3	-7.6	8.9	10.4	1.1
Net Dividend Growth	1.4	11.7	19.6	13.4	10.7	5.4
Earnings Growth	1.2	-4.7	7.1	17.4	19.2	7.4

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 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.*

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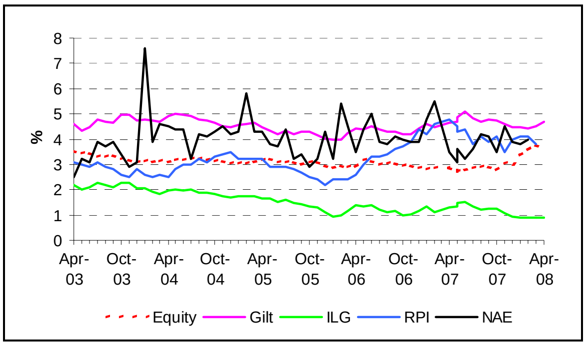
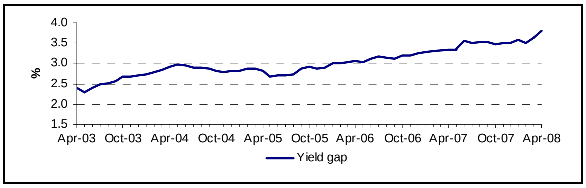
Yields and Yield Gaps

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.

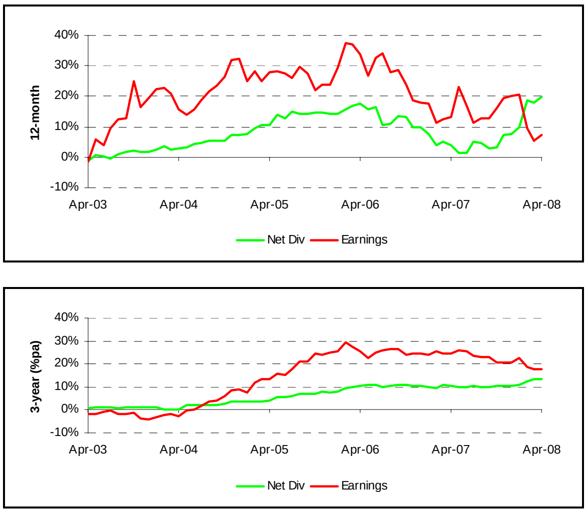


The gap is well through the 3.5% level, suggesting expectations of higher longer-term inflation as well as an increased risk premium for conventional bonds, relative to index-linked.

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*]

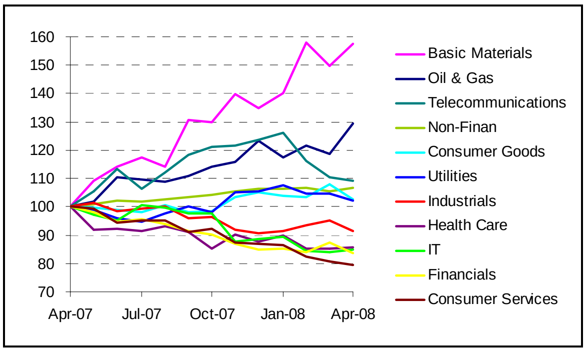
Figure 3: Dividend & Earnings Growth



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



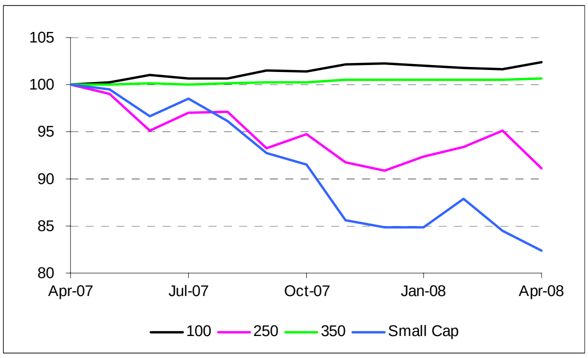
Note: Relative lines' labels for sectors in end-value order

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

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	16.0	15.6	23.9
Basic Materials	11.8	17.7	50.7
Industrials	2.0	4.6	-12.6
Consumer Goods	0.9	3.8	-1.8
Health Care	6.9	-0.2	-18.1
Consumer Services	4.6	-3.6	-23.9
Telecommunications	5.4	-9.2	4.6
Utilities	3.7	-0.5	-2.3
Non-Finan	7.8	5.5	2.3
Financials	2.0	3.1	-19.8
IT	7.0	-0.6	-18.8
All Share	6.3	4.9	-4.3

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Mid Cap and Small Cap both fell 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 -6% over the last 12 months, and 6% over the last three years, which is 2% per annum.

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Bond market information

Figure 5: £ Non-Gilt Credit Margins

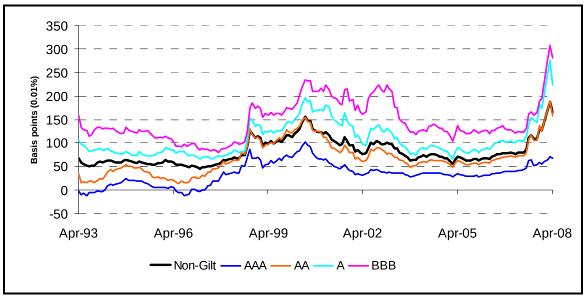

Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA (%)	FT 20 yr Gilt Yield (%)	Margin (%)
Nov 07	5.90	4.59	1.31
Dec 07	5.73	4.45	1.28
Jan 08	6.17	4.46	1.71
Feb 08	6.52	4.41	2.11
Mar 08	6.76	4.52	2.24
Apr 08	**6.46**	**4.70**	**1.76**

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

Category	Mkt Val (£bn @ Apr 08 & 06, 04)			Weight (%)
Gilts (27)	347	297	240	45.1
Non Gilts (1,125)	422	374	294	54.9
AAA (284)	160	141	108	20.9
AA (207)	63	58	40	8.2
A (391)	131	114	91	17.0
BBB (229)	65	57	50	8.5
Not rated (14)	3	4	6	0.3

Category	Mkt Val (£bn @ Apr 08 & 06)		W't (%)	Dur'n (yrs)
Gilts (27)	347	297	45.1	9.4
< 5 Yrs (8)	86	87	11.2	2.7
5–15 Yrs (9)	118	92	15.4	7.1
> 15 Yrs (10)	142	117	18.5	15.4
Non Gilts (1,125)	422	374	54.9	7.1
< 5 Yrs (343)	139	106	18.1	2.7
5–15 Yrs (474)	164	135	21.4	7.1
> 15 Yrs (308)	119	133	15.4	12.4

£ Gilt Market Issuance and Coverage

- £3.75bn of 4¾% 2010 (2.63x, yield 4.02%, prev Apr 05)
- £2.25bn of 4½% 2042 (1.69x, yield 4.57%, Feb 08)
- £1.2bn of ILG 1¼% 2017 (1.64x, r.y. 1.20%, Apr 07)
- £0.675bn of ILG 1¾% 2047 (2.28x, r.y. 0.72%, Jan 08)

- **iBoxx Sterling corporate:** 20 new sterling corporate issues (£8.3bn) from 18 issuers across the world, and aggregate net funding or redemption (+£2.5bn) by 10 (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 €92bn (including €29bn governments), and aggregate net funding or redemption (€40bn) of existing bonds (of which €35bn by governments). 29 bonds fell within 1 year of maturity. 5 early redemptions.

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

Category	Mkt Val (€bn @ Apr 08)	Weight (%)
Sovereigns (239)	3,183	60.5
Non Sovereigns	2,076	39.5
AAA (615)	1,096	20.8
AA (408)	436	8.3
A (457)	378	7.2
BBB (220)	166	3.2

Category	Mkt Val (€bn @ Apr 08)	Weight (%)
1 – 3 Yrs (490)	1,375	26.1
3 – 5 Yrs (481)	1,168	22.2
5 – 7 Yrs (355)	768	14.6
7 – 10 Yrs (397)	970	18.5
10+ Yrs (216)	977	18.6

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Apr 08 & 06)		W't (%)	Dur'n (yrs)
Gilts (14)	170	113	91.4	12.7
< 5 Yrs (2)	23	8	12.4	2.3
5 – 15 Yrs (5)	76	66	40.9	8.2
> 15 Yrs (7)	71	39	38.2	20.8
Non Gilts (56)	16	12	8.6	15.3

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

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