



Investment Headlines & Comment

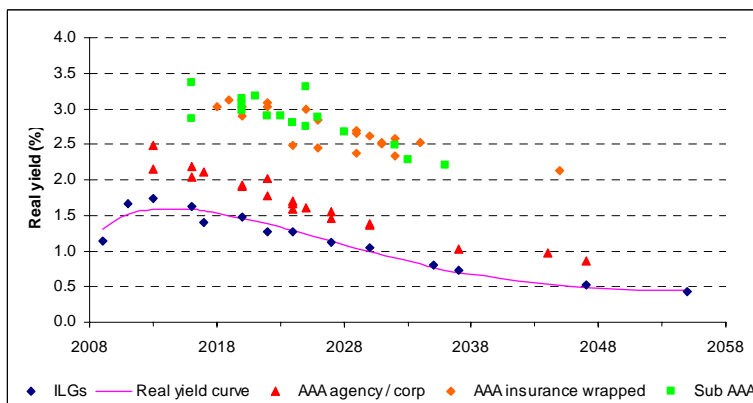
- **Commodities** were once again in the limelight. A return of 67% (!) in the last 12 months will have boosted those “multi asset” funds that happen to have included some exposure, but will they bank the profit and move on, or will they risk the ‘bubble’ bursting?
- **Inflation** expectations have moved up again (see page 3). The crude estimate from the yield curves has risen pretty inexorably from a long-run 2.5% in 2003 to a long-run 4% now. How much of this is due to fears of an ever more tax-and-spend government?
- **Moody’s** are reviewing whether a computer error resulted in incorrect AAA ratings for some complex debt instruments. The review of its computer coding does not cover subprime mortgages, CDOs or corporate bonds, but it is a useful warning.

Feature Section In May 2005, when the launch of the 2055 index-linked gilt (ILG) was imminent, we reviewed the state of the index-linked corporate bond market. Three years on, as real yields on long (and ultra-long) ILGs are at or near historic lows, we thought it worth updating readers on the profile of their corporate cousins.

The non-ILG proportion of the sterling index-linked market is a mere 8.6% (versus 91.4% for ILGs) and is thus still close to the proportion reported in May 2005, although there have been some 10 new issues over the period, including bonds from ‘big name’ issuers such as Network Rail, Tesco and Toyota; there was just 1 bond maturing in the last 3 years.

Within the 8.6%, just over 40% of this relates to 4 issuers: Network Rail now accounts for 2.0% (23% of the whole non-government market!), the European Investment Bank for 0.9%, Channel Tunnel for 0.4% and Tesco for 0.4%. All other issuing groups have smaller shares. Table 2f on page 4 of *Update* gives a compact monthly summary of the maturity profile of the ILG market. Figure 1 below shows the current set of individual ILG real yields, the associated yield curve, and plots the real yields on the 56 non-ILGs in the Barclays Capital index.

Figure 1: Sterling Index-linked bond yields



Sources: DMO, Barclays Capital, Jagger & Associates

for taking on the associated credit risk, possibly because of market sentiment having swung too far against taking on any credit risk (including the risk of the insurer failing to meet obligations).

On the practical side, there is a slight complication in that few (if any) investment managers offer specialist products in sterling index-linked corporate bonds. However, it would be relatively straightforward to generate rules for a manager for construction of an execution-only portfolio for those mandates large enough to be done on a segregated basis, and pooled bond funds may yet make greater use of them to enhance their returns.



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 May 2008

Asset Class	1 month (%)	3 months (%)	12 months (%)	3 years (% p.a.)	5 years (% p.a.)	10 years (% p.a.)
UK Equities	-0.2	3.9	-7.1	11.1	13.0	4.0
Overseas Equities	2.1	6.8	0.0	11.8	12.1	4.8
US Equities	1.8	6.6	-6.1	5.2	6.1	2.4
Europe ex UK Equities	2.3	8.4	1.6	18.7	18.3	6.2
Japan Equities	2.7	6.5	-5.6	7.6	11.8	3.7
Pacific ex Japan Equities	-1.2	1.1	12.6	23.5	23.9	12.4
Emerging Markets	2.1	4.9	22.2	29.9	29.4	13.9
UK Long-dated Gilts	-1.4	-2.7	4.5	2.2	3.2	5.4
UK Long-dated Corp. Bonds	-1.0	-1.1	-2.8	0.4	2.7	5.7
UK Over 5 Yrs Index-Linked Gilts	0.0	0.7	14.1	7.0	6.6	6.7
High Yield (Global)	0.7	5.3	0.3	4.3	4.9	3.7
Overseas Bonds	-1.3	-1.1	16.2	2.8	1.8	4.3
Property *	-0.5	-2.3	-11.7	7.0	10.3	10.4
Cash	0.5	1.5	6.2	5.4	5.0	5.2
Commodities £-converted	9.4	17.0	66.7	15.2	14.8	11.9
Hedge Funds original \$ basis *	1.6	0.8	3.1	10.3	10.9	9.0
Illustrative £-converted version *	1.9	1.2	4.1	8.9	6.2	7.1
Euro relative to Sterling	0.0	3.0	15.6	5.1	1.8	-
US \$ relative to Sterling	0.3	0.5	0.2	-2.7	-3.7	-1.9
Price Inflation (RPI) *	0.9	2.0	4.2	3.8	3.4	2.8
Price Inflation (CPI) *	0.8	2.0	3.0	2.6	2.2	1.7
Price Inflation (RPIX) *	0.9	2.2	4.0	3.3	2.9	2.6
Earnings Inflation **	-0.4	7.0	4.4	4.1	4.2	4.4
All Share Capital Growth	-0.6	2.3	-10.4	7.5	9.4	1.0
Net Dividend Growth	3.0	6.6	22.9	13.0	11.1	5.7
Earnings Growth	-4.4	-5.2	-3.4	14.6	17.0	7.0

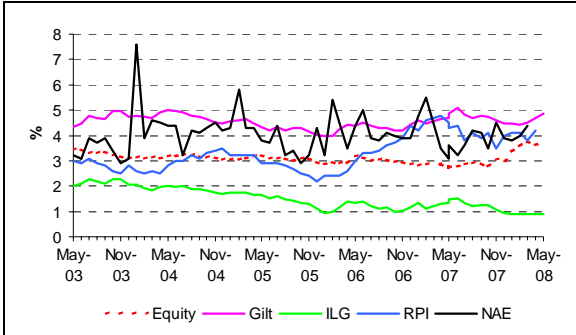
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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.

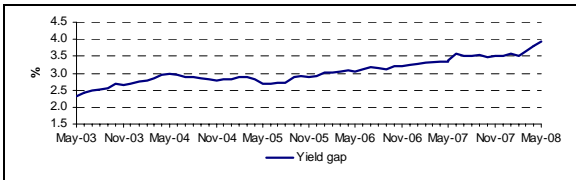


Yields and Yield Gaps

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.

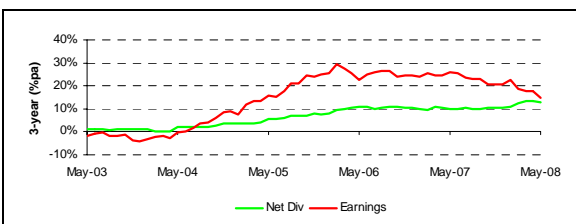
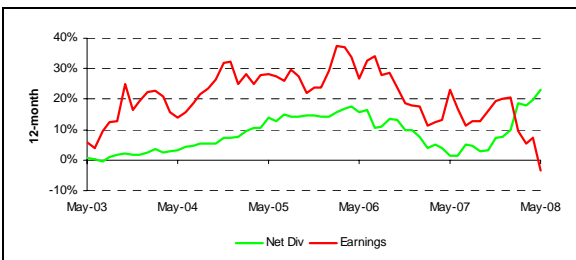


The gap is now nearing the 4% level, suggesting increased expectations of higher longer-term inflation as well as an increased risk premium for conventional bonds, relative to index-linked.

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]

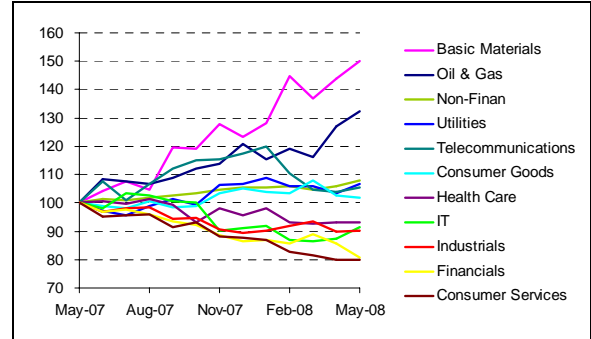
Figure 3: Dividend & Earnings Growth



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



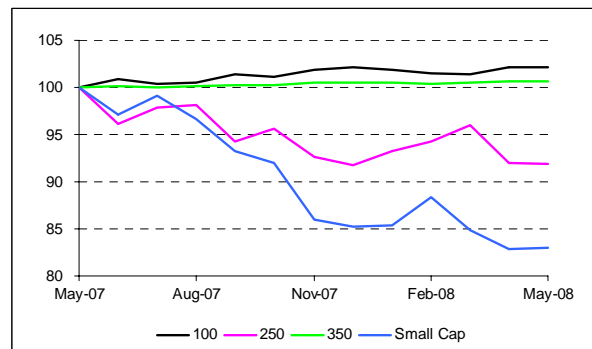
Note: Relative lines' labels for sectors in end-value order

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	4.0	15.3	22.9
Basic Materials	4.0	7.8	39.4
Industrials	0.2	2.0	-16.1
Consumer Goods	-1.2	2.0	-5.5
Health Care	-0.6	3.7	-13.7
Consumer Services	-0.5	0.2	-25.8
Telecommunications	1.3	-0.8	-2.1
Utilities	3.3	4.9	-0.7
Non-Finan	1.7	5.9	0.4
Financials	-5.9	-2.2	-25.1
IT	4.5	9.2	-15.2
All Share	-0.2	3.9	-7.1

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



There was little size-related movement this month.

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 -4% over the last 12 months, and 3% over the last three years, which is 1% per annum (i.e. this is far less volatile than in previous years).



Bond market information

Figure 5: £ Non-Gilt Credit Margins

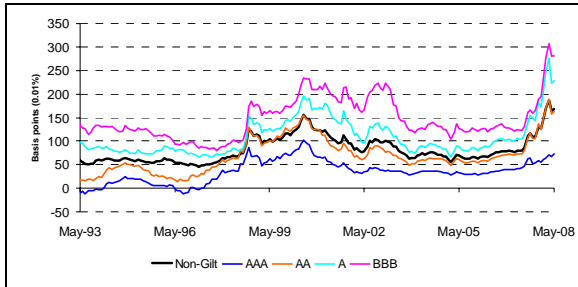


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA (%)	FT 20 yr Gilt Yield (%)	Margin (%)
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
May 08	6.45	4.86	1.59

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

Category	Mkt Val (£bn @ May 08 & 06, 04)			Weight (%)
Gilts (27)	342	306	238	45.1
Non Gilts (1,125)	416	386	290	54.9
AAA (284)	158	148	107	20.9
AA (207)	62	59	39	8.2
A (391)	129	117	90	17.0
BBB (229)	64	59	49	8.5
Not rated (14)	2	4	6	0.3

Category	Mkt Val (£bn @ May 08 & 06)		W't (%)	Dur'n (yrs)
Gilts (27)	342	306	45.1	9.4
< 5 Yrs (8)	85	87	11.3	2.6
5-15 Yrs (9)	116	95	15.3	7.1
> 15 Yrs (10)	140	123	18.5	15.5
Non Gilts (1,125)	416	386	54.9	7.0
< 5 Yrs (343)	137	110	18.1	2.6
5-15 Yrs (474)	161	141	21.3	7.0
> 15 Yrs (308)	117	135	15.5	12.3

£ Gilt Market Issuance and Coverage

- o £2.5bn of 5% 2018 (2.05x, yield 4.91%, prev Feb 08)
- o A new 2049 gilt will be issued in September
- o £0.9bn of ILG 1¹/₈% 2037 (1.99x, r.y. 0.76%, Feb 08)
- **iBoxx Sterling corporate:** 20 new sterling corporate issues (£7.3bn) from 17 issuers across the world, and aggregate net funding or redemption (+£2.2bn) by 7 (mostly non-UK) corporate or sub-sovereign issuers. 5 bonds redeemed early or eliminated. 9 bonds fell within 1 year of maturity.
- **iBoxx Euro:** New euro issues €11bn (including €26bn governments), and aggregate net funding or redemption (€33bn) of existing bonds (of which €28bn by governments). 27 bonds fell within 1 year of maturity. 3 early redemptions.

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

Category	Mkt Val (€bn @ May 08)	Weight (%)
Sovereigns (238)	3,117	59.9
Non Sovereigns	2,085	40.1
AAA (615)	1,080	20.8
AA (423)	456	8.8
A (465)	382	7.4
BBB (220)	167	3.2

Category	Mkt Val (€bn @ May 08)	Weight (%)
1 – 3 Yrs (511)	1,387	26.7
3 – 5 Yrs (478)	1,141	21.9
5 – 7 Yrs (355)	754	14.5
7 – 10 Yrs (400)	952	18.3
10+ Yrs (217)	968	18.6

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ May 08 & 06)		W't (%)	Dur'n (yrs)
Gilts (14)	170	118	91.4	12.6
< 5 Yrs (2)	23	8	12.4	2.2
5 – 15 Yrs (5)	75	68	40.3	8.1
> 15 Yrs (7)	71	41	38.2	20.8
Non Gilts (56)	16	12	8.6	15.3

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

