

Investment Update June 2008



Investment Headlines & Comment

- After a rally in April, and a fairly flat May, **Equities** were driven back down below their March 2008 levels this month, and conventional gilts and bonds also suffered, as inflation worries resurfaced. Meanwhile, real yields hit new lows on index-linked gilts. How will banks explain that duration risk is unrewarded if real yields ever revert to more plausible values?
- **Prudential** have announced that they will not be allocating 'orphan assets' to current policyholders, in contrast with **Norwich Union** who have previously indicated some bonus enhancements for relevant policies. Given the market volatility, Prudential may find the orphan assets 'cushion' useful, but who gets them if / when With Profits finally dies off as an out-dated concept?!
- Further to last month's Feature Section, more news on **Credit ratings** for collateralized and insurance wrapped bonds. Some £7bn of them were downgraded from AAA this month, mostly to AA. £1bn of Bradford & Bingley debt went from A rated to BBB. It is worth noting that there was no comparable move in the Euro bond indices – this seems to have been a Sterling bond quirk.

Feature Section In the light of the ratings news above, we thought it would be interesting to see just how uniform a position corporate bond yields have reached within each credit rating group. It is arguable that some variation should be expected by industry sector within each rating group, but if there is too much, then that gives cause to doubt the overall reliability or speed of updating of the credit ratings being quoted. Figures 1a-1d show the plots of yields against maturity date for each of the main investment grade ratings. The same scale is used for ease of comparison. (Source: iBoxx)

Figure 1a: AAA

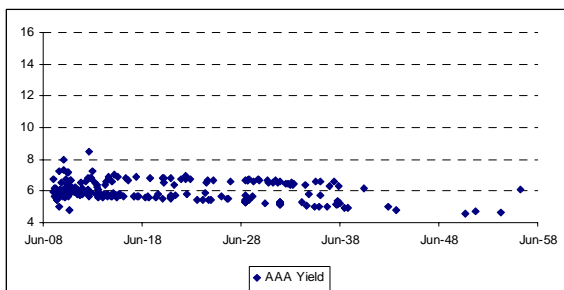


Figure 1c: A

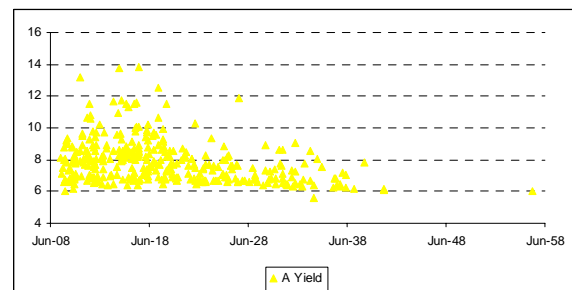


Figure 1b: AA

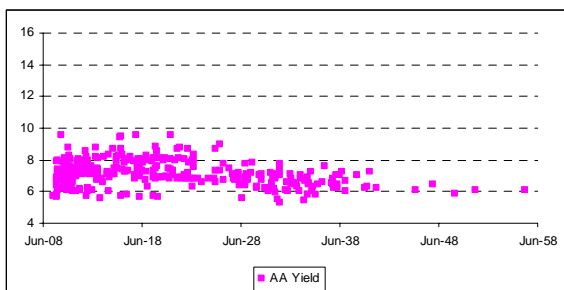
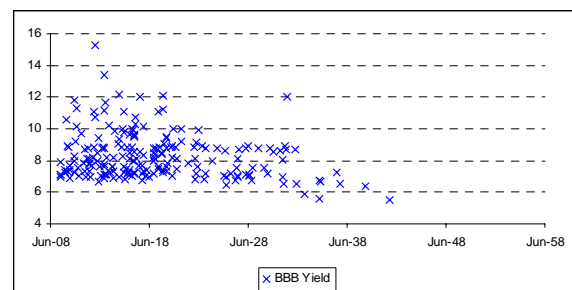


Figure 1d: BBB



Within AAA, there is some evidence of fairly smooth lines that could be drawn through two sub-sets, with these covering cases such as sovereign bonds and public banks respectively. Within AA, there is a wider spread, including some bonds that are being priced as if they were AAA rated – there were some instances of upward rating moves in the Euro market this month, so it can happen! By the time you get to the A and BBB groups, the dispersion in yields over even just the next 10 years is really pronounced, which implies that there should be plenty of opportunities for active bond managers (although whether they can get them right is another matter entirely).



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 June 2008

Asset Class	1 month (%)	3 months (%)	12 months (%)	3 years (% p.a.)	5 years (% p.a.)	10 years (% p.a.)
UK Equities	-7.1	-1.4	-13.0	7.2	11.3	3.5
Overseas Equities	-9.3	-1.9	-7.6	7.3	9.6	3.8
US Equities	-9.0	-2.5	-11.8	1.2	4.0	1.2
Europe ex UK Equities	-10.3	-4.3	-7.4	13.3	15.6	5.2
Japan Equities	-7.5	2.3	-11.1	4.3	8.6	3.1
Pacific ex Japan Equities	-11.2	-5.0	-2.7	16.6	19.8	12.3
Emerging Markets	-10.6	-0.9	5.7	23.1	25.4	14.1
UK Long-dated Gilts	-1.1	-4.0	6.0	1.2	3.4	5.2
UK Long-dated Corp. Bonds	-1.2	-1.3	-1.6	-0.8	2.7	5.5
UK Over 5 Yrs Index-Linked Gilts	2.5	1.2	17.2	7.2	7.1	6.8
High Yield (Global)	-3.4	1.6	-0.2	2.0	3.8	3.5
Overseas Bonds	-0.2	-4.5	18.5	2.4	2.3	4.5
Property *	-0.7	-2.0	-13.0	6.3	9.9	10.2
Cash	0.5	1.5	6.2	5.4	5.1	5.2
Commodities £-converted	8.4	28.5	77.4	15.6	16.8	13.5
Hedge Funds original \$ basis *	1.9	1.2	3.0	10.6	10.5	9.5
Illustrative £-converted version *	2.1	1.7	3.2	7.6	6.5	7.4
Euro relative to Sterling	0.7	-0.7	17.7	5.5	2.6	-
US \$ relative to Sterling	-0.7	-0.1	0.8	-3.5	-3.7	-1.7
Price Inflation (RPI) *	0.5	1.8	4.3	3.9	3.5	2.8
Price Inflation (CPI) *	0.7	1.9	3.3	2.7	2.3	1.7
Price Inflation (RPIX) *	0.7	2.2	4.3	3.5	3.0	2.6
Earnings Inflation **	-8.4	-4.6	3.1	3.3	3.7	3.8
All Share Capital Growth	-7.4	-2.4	-16.1	3.7	7.7	0.4
Net Dividend Growth	1.3	5.9	24.5	13.7	11.5	5.8
Earnings Growth	-0.4	-3.6	-4.5	14.0	17.0	7.0

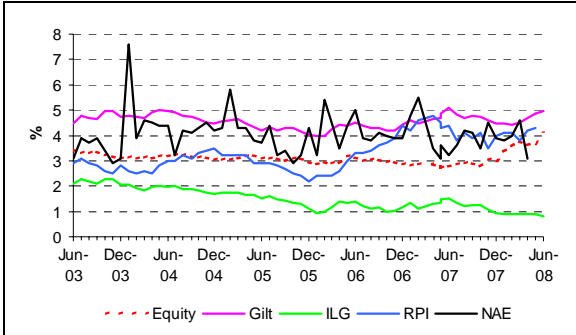
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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.

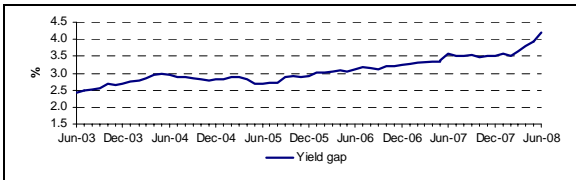


Yields and Yield Gaps

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.

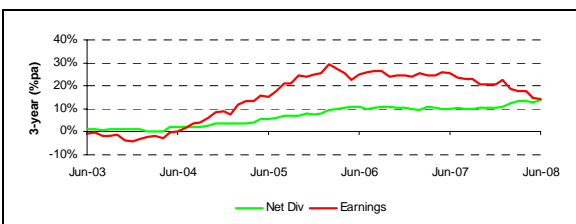
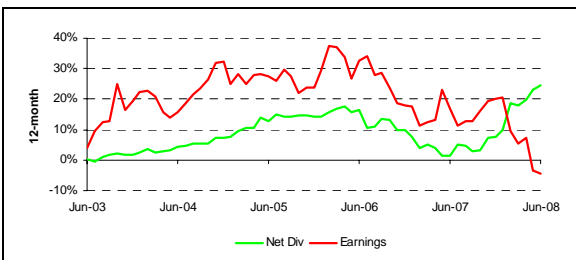


The gap is now through the 4% level, suggesting increased expectations of higher longer-term inflation as well as an increased risk premium for conventional bonds, relative to index-linked.

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]

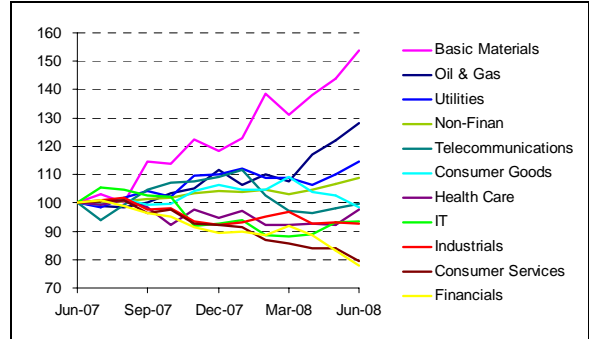
Figure 3: Dividend & Earnings Growth



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



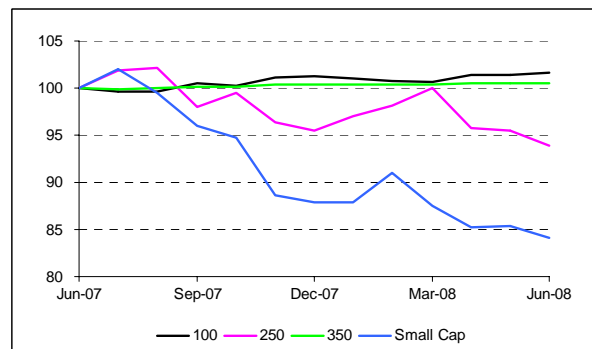
Note: Relative lines' labels for sectors in end-value order

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	-2.4	17.6	11.5
Basic Materials	-0.5	15.6	33.8
Industrials	-7.4	-5.3	-19.2
Consumer Goods	-10.7	-11.0	-14.2
Health Care	-1.6	4.6	-15.0
Consumer Services	-11.9	-8.3	-30.8
Telecommunications	-5.6	0.8	-13.3
Utilities	-3.3	3.7	-0.4
Non-Finan	-5.1	4.1	-5.2
Financials	-13.2	-16.6	-32.3
IT	-6.6	4.5	-18.5
All Share	-7.1	-1.4	-13.0

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Again, 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 -3% 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

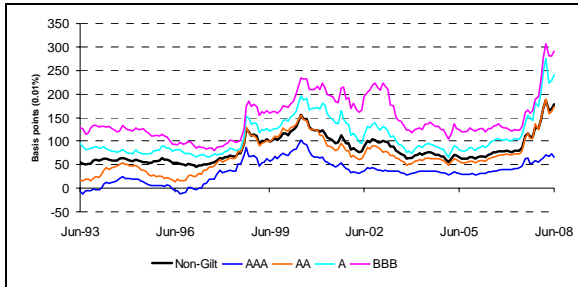


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA (%)	FT 20 yr Gilt Yield (%)	Margin (%)
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
Jun 08	6.63	4.98	1.65

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

Category	Mkt Val (£bn @ June 08 & 06, 04)			Weight (%)
Gilts (27)	343	306	245	45.0
Non Gilts (1,126)	419	386	297	55.0
AAA (241)	148	147	109	19.4
AA (237)	72	64	42	9.4
A (392)	131	113	91	17.1
BBB (242)	67	58	50	8.8
Not rated (14)	2	4	5	0.3

Category	Mkt Val (£bn @ June 08, 06)		W't (%)	Dur'n (yrs)
Gilts (27)	343	306	45.0	9.2
< 5 Yrs (8)	88	89	11.5	2.6
5-15 Yrs (9)	116	119	15.3	7.0
> 15 Yrs (10)	139	98	18.2	15.3
Non Gilts (1,126)	419	386	55.0	7.0
< 5 Yrs (333)	138	112	18.2	2.6
5-15 Yrs (482)	163	148	21.4	7.0
> 15 Yrs (311)	118	126	15.4	12.3

£ Gilt Market Issuance and Coverage

- o £2.25bn of 4¼% 2055 (1.49x, yield 4.40%, prev Apr 06)
- o £3.5bn of 4½% 2013 (1.91x, yield 5.33%, Mar 08)
- o £1.1bn of ILG 17/8% 2022 (1.58x, r.y. 1.31%, Jan 08)
- o £0.65bn of ILG ¾% 2047 (1.64x, r.y. 0.46%, Apr 08)

- **iBoxx Sterling corporate:** 16 new sterling corporate issues (£6bn) from 16 issuers across the world (mostly banks), and aggregate net funding (+£1.2bn) by 12 (mostly non-UK) corporate or sub-sovereign issuers. 11 bonds redeemed early or eliminated. 7 bonds fell within 1 year of maturity.
- **iBoxx Euro:** New euro issues €73bn (including €19bn governments), and aggregate net funding or redemption (€40bn) of existing bonds (of which €33bn by governments). 18 bonds fell within 1 year of maturity. 3 early redemptions.

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

Category	Mkt Val (€bn @ June 08)	Weight (%)
Sovereigns (242)	3,111	59.7
Non Sovereigns	2,104	40.3
AAA (622)	1,074	20.6
AA (439)	477	9.2
A (467)	370	7.1
BBB (238)	183	3.5

Category	Mkt Val (€bn @ June 08)	Weight (%)
1 – 3 Yrs (528)	1,392	26.7
3 – 5 Yrs (496)	1,159	22.2
5 – 7 Yrs (352)	738	14.2
7 – 10 Yrs (414)	953	18.3
10+ Yrs (218)	973	18.7

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ June 08 & 06)		W't (%)	Dur'n (yrs)
Gilts (13)	167	117	90.8	13.5
< 5 Yrs (1)	14	8	7.6	3.0
5 – 15 Yrs (5)	78	68	42.4	8.1
> 15 Yrs (7)	75	41	40.8	20.9
Non Gilts (56)	17	12	9.2	15.7

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

