JAGGER & ASSOCIATES

Investment Update
July 2008

Investment Headlines & Comment

- Sharp reversals for **commodities** and related equity sectors this month, but only really enough to remove the latest quarter's effects.
- Signs that demand for long-dated **index linked gilts** is slowing, as the DMO auctions were not really much oversubscribed.
- Major intra-month volatility for **equity markets** – eg the FTSE 100 dropped by almost 10% but recovered by about 6%.

Feature Section

As discussed in our October 2005 *Update*, there is no secondary mortgage market in the UK as yet – if such a market develops, it would introduce a further source of bond investments, since holders of these investments would be receiving a portfolio of mortgage interest and redemption payments spread across a lot of payment sources (i.e. homeowners). The US has two fairly well-known secondary market participants, Fannie Mae and Freddie Mac, who have been much in the news lately. As the US housing market has fallen, Fannie Mae and Freddie Mac have reported a combined loss of around $11bn. However the crisis in the US mortgage market means that these two institutions are now more important than ever, so we felt it worth updating our October 2005 item for readers.

Fannie Mae and Freddie Mac are US government-sponsored enterprises (GSEs), and their names come (somewhat tenuously) from the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation. The two organisations have formidable balance sheets – their combined assets total $1,700bn, and they hold or guarantee about $5,200bn of loans which is about 50% of the current US national debt. Neither makes any direct loans to homebuyers (in the primary market); both are purely listed companies operating in the secondary market. Typically, these organizations take mortgage loans and repackage them in the form of mortgage-backed securities. These securities are then sold to investors and Fannie Mae (or Freddie Mac) guarantees that the loans are repaid. In addition, these entities borrow money from debt markets and use it to buy mortgages they hold as their own investments, thus (theoretically) injecting money into the US housing economy.

Figure 1: 5 –year total return history (rebased to 100 at start)

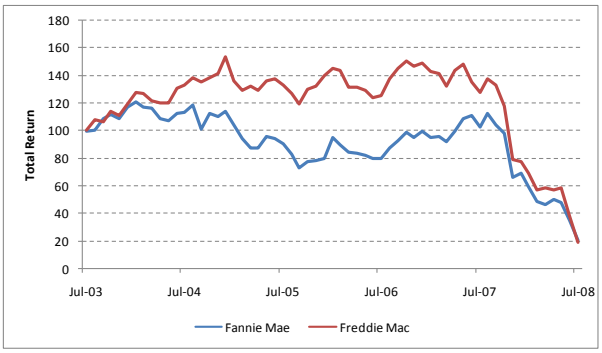


Figure 1 shows the cumulative total returns of both Fannie Mae and Freddie Mac over the past five years to 30 June 2008 – down by some 80% each. Following the publication of their respective write-downs of mortgage securities in Q3 07, their stock prices tumbled and accusations of insolvency were heard throughout the market place and the media. Subsequently, there has been a further dramatic slump in recent months, corresponding with the period in which the US Treasury has put into place a rescue package including an "unlimited" credit line, borrowing privileges and a pledge of a capital injection from the government if needed. There is a clear parallel with the severity of the decline in the UK for housebuilders (and financial organsiations reliant on the property sector).

A key area for both organisations (as it is for building societies in the UK) is managing the financial risks within their balance sheets, for example through structured interest rate derivatives. However, the problem in the US is that the vast size of the contracts involved means that they can be rather illiquid, and will involve a narrow range of counterparties. We concluded in a previous article that, if things did go wrong, they would almost certainly go very very wrong and this seems to have been borne out by recent events.

Now that the US Government has implicitly guaranteed both Fannie Mae and Freddie Mac's loan book, it is hoped that they will not have to use the emergency back stops put into place by the US Treasury. In the short term the emergency measures implemented have been effective, but it is too soon to say that this will work in the long term. What seems clear is that the US government regards these two institutions as "too big to fail".

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 July 2008

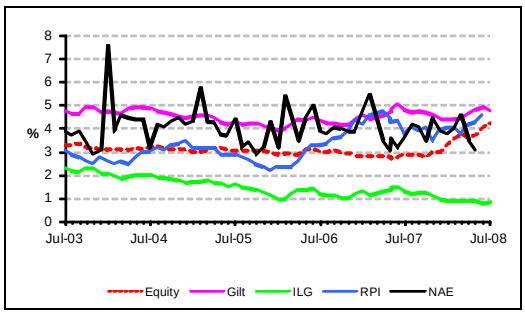
Asset Class	1 month (%)	3 months (%)	12 months (%)	3 years (% p.a.)	5 years (% p.a.)	10 years (% p.a.)
UK Equities	-3.6	-10.6	-13.3	4.7	9.7	3.1
Overseas Equities	-1.7	-8.9	-6.7	4.6	8.2	3.5
US Equities	-0.3	-7.7	-8.2	-0.8	3.1	1.1
Europe ex UK Equities	-2.1	-10.2	-6.8	9.9	13.9	4.4
Japan Equities	-2.9	-7.8	-12.1	2.4	6.5	2.7
Pacific ex Japan Equities	-1.9	-14.0	-7.8	13.2	17.5	12.2
Emerging Markets	-3.3	-11.6	-1.7	18.3	22.4	13.2
UK Long-dated Gilts	3.0	0.4	4.8	2.6	4.7	5.4
UK Long-dated Corp. Bonds	1.9	-0.4	-0.9	0.0	3.5	5.6
UK Over 5 Yrs Index-Linked Gilts	-0.3	2.2	13.3	7.4	7.6	6.6
High Yield (Global)	-1.3	-4.0	2.8	0.4	3.3	3.1
Overseas Bonds	0.5	-1.0	17.1	2.3	2.5	4.3
Property *	-1.5	-2.7	-14.9	5.2	9.4	9.9
Cash	0.5	1.5	6.2	5.5	5.1	5.2
Commodities £-converted	-11.8	4.6	50.0	8.2	13.2	12.8
Hedge Funds original $ basis *	-1.1	2.4	1.1	9.6	10.0	9.4
Illustrative £-converted version *	-1.8	2.3	2.0	5.8	5.9	7.4
Euro relative to Sterling	-0.6	0.2	16.9	4.5	2.4	-
US $ relative to Sterling	0.5	0.0	2.5	-3.9	-4.1	-1.9
Price Inflation (RPI) *	0.8	2.2	4.6	4.1	3.6	2.9
Price Inflation (CPI) *	0.6	2.2	3.8	2.9	2.5	1.8
Price Inflation (RPIX) *	0.8	2.5	4.8	3.8	3.2	2.7
Earnings Inflation **	0.4	-7.9	3.1	3.7	3.9	3.9
All Share Capital Growth	-3.7	-11.3	-16.4	1.3	6.1	0.1
Net Dividend Growth	0.5	4.9	24.1	13.0	11.6	5.8
Earnings Growth	0.7	-4.1	-1.1	13.9	17.2	7.1

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

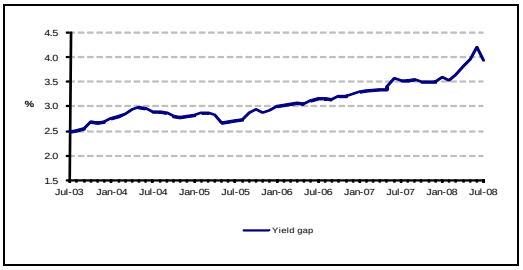
- *UK Equities (incl. dividends and earnings) – FT-A All Share.*
- *Overseas Equities (incl. regions) – blend of FT All-World / World subindices*
- *Emerging Markets from MSCI US $ based total return index (overall Index to 31 Oct 2001, Free Index from 1 Nov 2001 to take account of foreign investment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

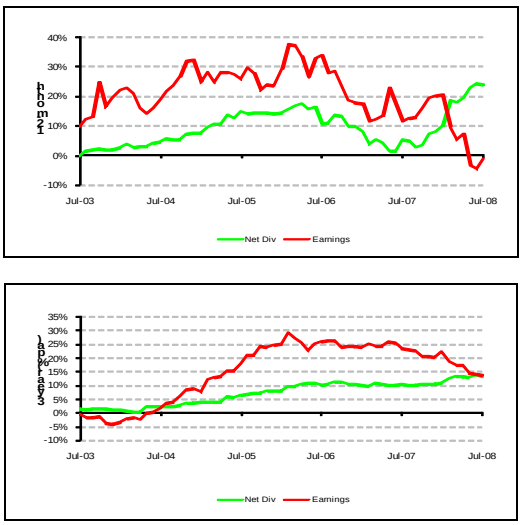


The gap has come back through the 4% level, suggesting slightly lower expectations of higher longer-term inflation + risk premium for conventional bonds, relative to index-linked.

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*]

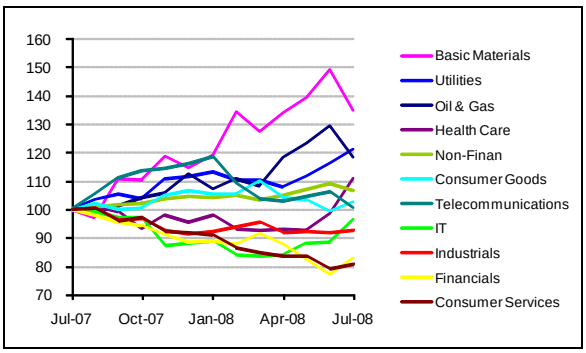
Figure 3: Dividend & Earnings Growth



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



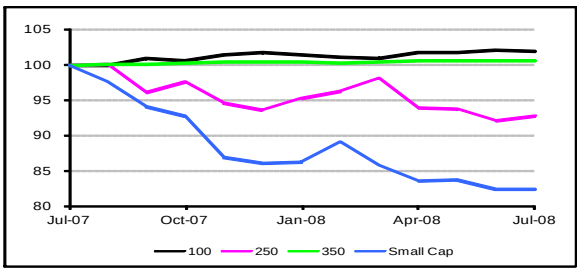
Note: Relative lines' labels for sectors in end-value order

Basic Materials were still strongest over the last 12 months but by a much reduced margin.

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	-11.9	-10.7	2.5
Basic Materials	-12.9	-9.9	17.1
Industrials	-2.8	-9.8	-19.7
Consumer Goods	-0.4	-12.1	-10.9
Health Care	8.3	6.0	-4.0
Consumer Services	-1.8	-13.9	-30.1
Telecommunications	-8.7	-12.6	-12.8
Utilities	0.7	0.6	5.2
Non-Finan	-5.8	-9.0	-7.3
Financials	3.7	-15.3	-28.0
IT	4.6	2.1	-16.4
All Share	-3.6	-10.6	-13.3

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 -4% over the last 12 months, and -2% 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

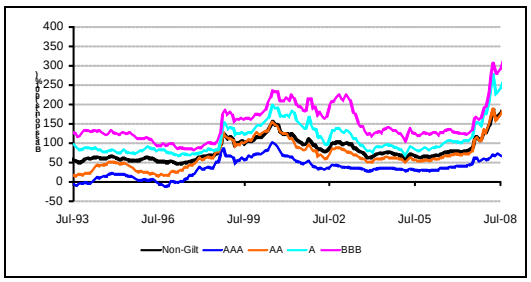


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA (%)	FT 20 yr Gilt Yield (%)	Margin (%)
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
Jul 08	**6.51**	**4.76**	**1.75**

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

Category	Mkt Val (£bn @ July 08 & 06, 04)			Weight (%)
Gilts (27)	362	307	246	46.0
Non Gilts (1,123)	426	392	298	54.0
AAA (240)	151	148	110	19.2
AA (240)	74	64	42	9.4
A (390)	131	115	91	16.7
BBB (239)	66	61	50	8.4
Not rated (14)	2	4	5	0.3

Category	Mkt Val (£bn @ July 08, 06)		W't (%)	Dur'n (yrs)
Gilts (27)	362	307	46.0	9.3
< 5 Yrs (8)	92	91	11.7	2.6
5–15 Yrs (9)	122	113	15.5	6.9
> 15 Yrs (10)	147	103	18.7	15.5
Non Gilts (1,123)	426	392	54.0	7.0
< 5 Yrs (333)	141	112	17.9	2.5
5–15 Yrs (478)	164	152	20.9	7.0
> 15 Yrs (312)	121	129	15.3	12.4

£ Gilt Market Issuance and Coverage

- £2.25bn of 4½% 2042 (1.55x, yield 4.70%, prev Apr 08)
- £3.75bn of 5% 2012 (1.65x, yield 4.91%, Mar 02)
- £2.5bn of 5% 2018 (2.47x, yield 5.00%, May 08)
- £0.85bn of ILG $1^{1}/_{8}$% 2037 (1.10x, r.y. 0.73%, May 08)
- £1.05bn of ILG 1¼% 2027 (1.20x, r.y. 1.16%, Mar 08)

- **iBoxx Sterling corporate:** 6 new issues (£2.4bn), and aggregate net funding (+£1.8bn) by 9 corporate or sub-sovereign issuers. 6 bonds redeemed early or eliminated (including 2 2038 cases). 7 bonds within 1 year of maturity.

- **iBoxx Euro:** New euro issues €31bn (including €8bn governments), and aggregate net funding or redemption (€56bn) of existing bonds (of which €50bn by governments). 31 bonds fell within 1 year of maturity. 5 early redemptions.

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

Category	Mkt Val (€bn @ July 08)	Weight (%)
Sovereigns (244)	3,156	59.4
Non Sovereigns	2,162	40.6
AAA (627)	1,092	20.5
AA (438)	482	9.1
A (492)	399	7.5
BBB (241)	188	3.5

Category	Mkt Val (€bn @ July 08)	Weight (%)
1 – 3 Yrs (556)	1,410	26.5
3 – 5 Yrs (499)	1,182	22.2
5 – 7 Yrs (370)	759	14.3
7 – 10 Yrs (405)	969	18.2
10+ Yrs (212)	998	18.8

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ July 08 & 06)		W't (%)	Dur'n (yrs)
Gilts (13)	169	123	90.9	13.6
< 5 Yrs (1)	14	8	7.5	2.9
5 – 15 Yrs (5)	77	70	41.4	8.1
> 15 Yrs (7)	77	45	41.4	21.0
Non Gilts (56)	17	12	9.1	15.7

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

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