JAGGER & ASSOCIATES

Investment Update
August 2008

Investment Headlines & Comment

- **Sterling** has weakened markedly against the **US Dollar** this month, having fallen heavily against the **Euro** over the last year.
- **Gartmore** have poached a long-serving senior equity manager from **Threadneedle** to be their new CIO.
- **Norwich Union** have made a mid-year reduction to terminal bonuses, reflecting the weak asset market returns in 2008 thus far.

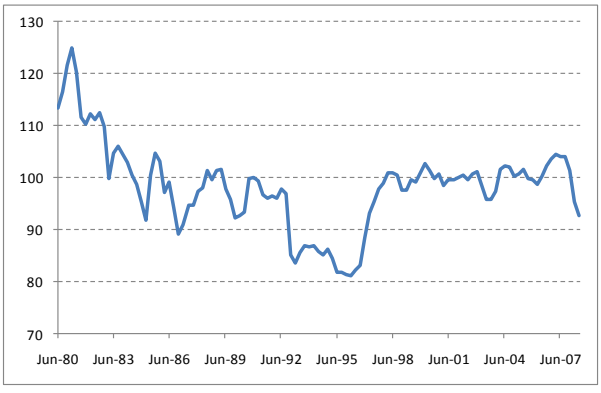
Feature Section

If a UK investor has an overseas investment denominated in a currency other than Sterling, they experience currency fluctuations as well as to movements in the underlying asset prices. Starting with no change in those prices, then if Sterling decreases in value relative to the underlying currencies then the Sterling value of the investment will increase proportionally (as happened this month for US investments, and for Euro ones over the last 12 months), but if the value of Sterling increases then the Sterling value of the investment will fall.

One way in which to hedge (remove) currency exposure is to sell "forward foreign exchange contracts", converting the relevant currency back to sterling at a fixed (future) rate, which can be better or worse than the current rate. There can thus be cost associated with this activity, akin to an insurance premium. Historically, few UK institutional investors have hedged their currency exposure, although many companies will have done so. (There is arguably a slight paradox here, but the differing time horizons involved may be relevant.)

There have been two major academic studies into the effects of currency hedging. One was conducted in 1988 by Lee Thomas who investigated the impact of currency fluctuations for a US investor with holdings in European and Japanese equities. The other study was conducted by Phillipe Jorion in 1989. It was similar to Thomas's, but Jorion studied investments in equities and bonds issued in Europe, Asia and Australia. Both of these studies concluded that, over longer periods, returns on hedged portfolios have been similar to those unhedged portfolios but hedged portfolios have generally been significantly less volatile than unhedged portfolios. However, we do not think either study considered investors who try to add value by moving between hedged and unhedged, according to whether the hedging cost is 'fair'. We will explore the effect of this in more detail in next month's *Investment Update*.

Figure 1: Sterling (EER) Index History



Source: Bank of England

Figure 1 shows the Sterling Effective Exchange Rate (EER) Index over the past 28 years on a rolling quarterly basis. This index is compiled by the Bank of England and represents the trade-weighted average of various foreign exchange rates relative to Sterling (so if the index is above 100 this implies that Sterling is "strong" while if it is below 100 this implies that Sterling is "weak").

This figure shows that the Sterling EER has experienced significant short-term volatility, for example a negative shift around the time when Sterling exited the Exchange Rate Mechanism (ERM), with a long downward trend before that.

There was also quite a long period of stability in the late 1990s / early 2000s. The average value of the index over the 28 years is 98.4, suggesting that on average Sterling has been slightly weaker than expected, but not to any significant extent. However, this is not the same as saying a hedged Overseas Equity portfolio would have produced very similar returns to those of an otherwise identical but unhedged portfolio – for that conclusion, you have to plough through the data, and some interesting patterns emerge, of which more next month.

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 August 2008

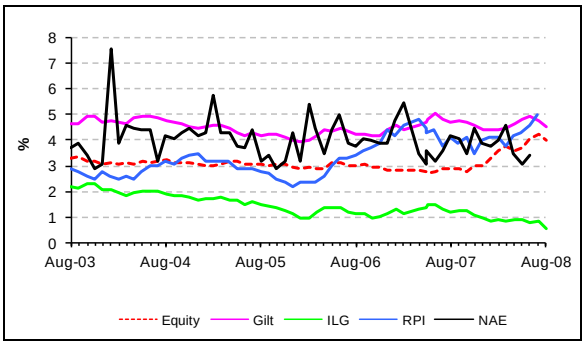
Asset Class	1 month (%)	3 months (%)	12 months (%)	3 years (% p.a.)	5 years (% p.a.)	10 years (% p.a.)
UK Equities	5.0	-5.9	-8.7	6.0	10.4	4.7
Overseas Equities	6.4	-5.1	-1.4	7.4	8.6	6.0
US Equities	**10.2**	0.0	-1.1	3.6	4.4	**4.0**
Europe ex UK Equities	3.2	-9.4	-3.2	11.6	14.2	6.7
Japan Equities	4.3	-6.3	-6.2	2.3	5.0	4.6
Pacific ex Japan Equities	1.8	-11.3	-5.3	15.3	16.1	14.4
Emerging Markets	0.0	**-13.5**	-0.3	**18.9**	**20.3**	**17.1**
UK Long-dated Gilts	2.5	4.4	5.6	2.7	4.9	5.2
UK Long-dated Corp. Bonds	2.2	2.8	0.4	**0.1**	3.7	5.6
UK Over 5 Yrs Index-Linked Gilts	4.7	6.9	16.4	8.2	8.4	6.9
High Yield (Global)	8.1	3.1	9.4	3.6	4.3	4.7
Overseas Bonds	7.0	**7.3**	**22.1**	4.8	**3.6**	5.0
Property *	**-1.3**	-3.5	**-16.1**	4.3	8.9	9.6
Cash	0.5	1.5	6.1	5.5	5.1	5.2
Commodities £-converted	0.9	-3.5	56.9	4.5	12.0	13.7
Hedge Funds original $ basis *	-2.2	-1.7	-1.3	7.9	9.2	9.2
Illustrative £-converted version *	-1.8	-1.7	1.2	3.7	4.7	7.1
Euro relative to Sterling	2.5	2.7	19.5	5.7	3.1	-
US $ relative to Sterling	8.6	8.3	10.6	-0.4	-2.9	-0.9
Price Inflation (RPI) *	-0.1	1.2	5.0	4.0	3.6	2.9
Price Inflation (CPI) *	0.0	1.3	4.4	2.9	2.5	1.8
Price Inflation (RPIX) *	-0.2	1.4	5.3	3.7	3.1	2.7
Earnings Inflation **	1.4	-6.4	3.4	3.9	3.9	4.0
All Share Capital Growth	4.3	-6.9	-12.0	2.6	6.8	1.6
Net Dividend Growth	-1.8	0.1	20.8	12.0	11.1	5.5
Earnings Growth	-5.6	-5.3	-10.0	9.0	15.4	6.5

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

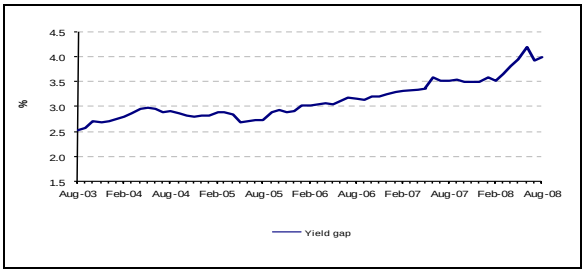
- *UK Equities (incl. dividends and earnings) – FT-A All Share.*
- *Overseas Equities (incl. regions) – blend of FT All-World / World subindices*
- *Emerging Markets from MSCI US $ based total return index (overall Index to 31 Oct 2001, Free Index from 1 Nov 2001 to take account of foreign investment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

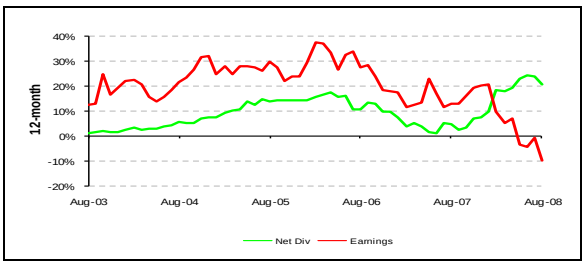


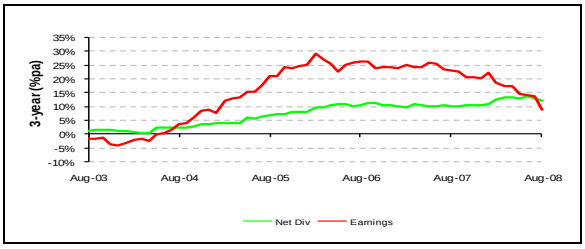
The gap has stayed near the 4% level, suggesting expectations of higher longer-term inflation + risk premium for conventional bonds, relative to index-linked.

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

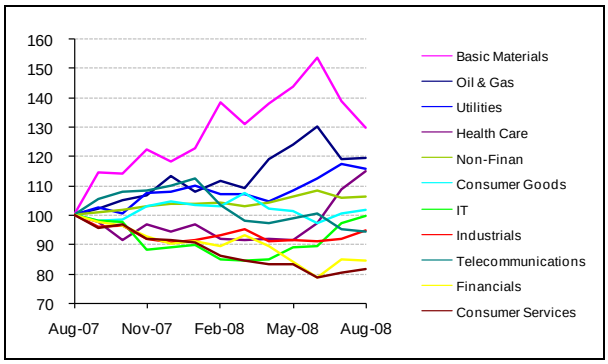




Sources for charts on this page:
Financial Times, Office for National Statistics, J&A

UK Equity Sector Returns

Figure 4a: Sectors relative to All Share



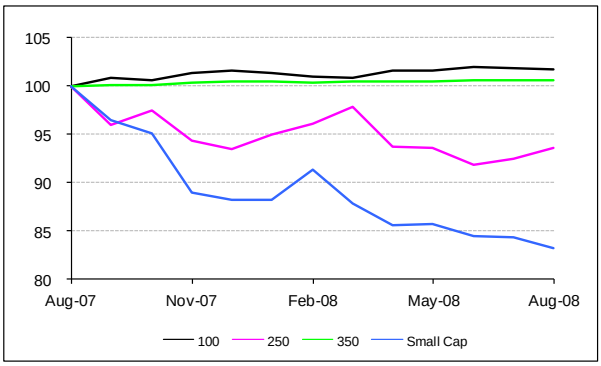
Note: Relative lines' labels for sectors in end-value order

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	5.5	-9.4	9.2
Basic Materials	-1.9	-15.0	18.4
Industrials	8.2	-2.6	-13.4
Consumer Goods	6.5	-5.3	-7.0
Health Care	10.8	18.2	5.1
Consumer Services	6.9	-7.5	-25.3
Telecommunications	4.1	-10.2	-13.8
Utilities	3.6	0.9	6.0
Non-Finan	5.2	-6.0	-3.0
Financials	4.5	-5.9	-23.1
IT	7.6	5.1	-9.3
All Share	5.0	-5.9	-8.7

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Again, there was relatively 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 -1% 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

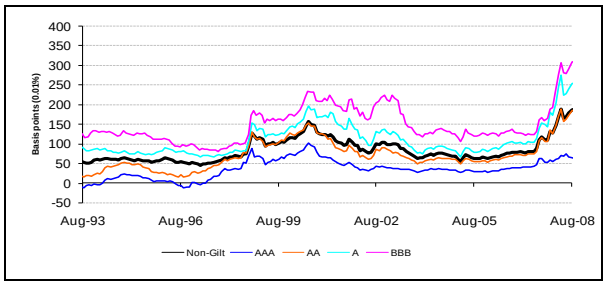


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA (%)	FT 20 yr Gilt Yield (%)	Margin (%)
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
Aug 08	**6.33**	**4.55**	**1.78**

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

Category	Mkt Val (£bn @ Aug 08 & 06, 04)			Weight (%)
Gilts (27)	369	312	257	46.1
Non Gilts (1,123)	433	395	308	53.9
AAA (240)	154	149	117	19.2
AA (240)	75	64	41	9.4
A (390)	134	119	93	16.7
BBB (239)	67	59	52	8.4
Not rated (14)	3	4	5	0.3

Category	Mkt Val (£bn @ Aug 08, 06)		W't (%)	Dur'n (yrs)
Gilts (27)	369	312	46.1	9.4
< 5 Yrs (8)	94	91	11.7	2.5
5–15 Yrs (9)	125	116	15.6	7.0
> 15 Yrs (10)	151	105	18.8	15.6
Non Gilts (1,123)	433	395	53.9	7.0
< 5 Yrs (333)	142	111	17.7	2.5
5–15 Yrs (478)	167	153	20.9	6.9
> 15 Yrs (312)	123	131	15.3	12.4

£ Gilt Market Issuance and Coverage

- £2.25bn of 4¾% 2030 (1.58x, yield 4.84%, prev Mar 08)
- £0.925bn of ILG $1^{1}/_{8}$% 2037 (1.52x, r.y. 0.52%, July 08)
- A new 2032 ILG will be issued in Q4 2008.

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

Category	Mkt Val (€bn @ Aug 08)	Weight (%)
Sovereigns (238)	3,147	59.2
Non Sovereigns	2,171	40.8
AAA (625)	1,098	20.7
AA (423)	470	8.9
A (510)	419	7.9
BBB (234)	184	3.5

Category	Mkt Val (€bn @ Aug 08)	Weight (%)
1 – 3 Yrs (564)	1,426	26.8
3 – 5 Yrs (494)	1,173	22.1
5 – 7 Yrs (365)	755	14.2
7 – 10 Yrs (401)	972	18.3
10+ Yrs (206)	992	18.6

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Aug 08 & 06)		W't (%)	Dur'n (yrs)
Gilts (13)	175	125	90.7	13.6
< 5 Yrs (1)	14	21	7.3	2.9
5 – 15 Yrs (5)	80	58	41.5	8.0
> 15 Yrs (7)	81	46	42.0	21.0
Non Gilts (56)	18	13	9.3	15.7

Table 2g: High Yield Market (BB-B indices)

Month End	US	Euro	Sterling
Apr 08	9.32	10.01	11.85
May 08	9.39	10.15	11.81
Jun 08	10.01	11.86	11.83
Jul 08	10.51	12.54	12.64
Aug 08	10.41	12.45	12.57

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

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