



Investment Update September 2008

Investment Headlines & Comment

- A month without parallel in its volatility and the banking rescue activity. **Credit spreads** have rocketed and the **LIBOR** rate has moved well ahead of base rates.
- **Lehman Brothers'** demise acted as a counterparty test for collateral-supported LDI – small losses for some, and the hassle of setting up replacement swaps.
- **Commodities** had a poor month, and **basic materials** likewise (particularly the mining sector) – see p3 for a demonstration of just how rapid the decline has been.

Feature Section

Last month we looked at the effects of currency hedging for a UK investor. This month we look into the practicality of currency hedging and the associated “insurance premium” cost. Analysis of FT market data for the last 9 years shows that the average 3-month hedged return on the US \$ was -0.3%, and on the Euro -0.4%. There was very little variation in these figures – markets appear to “anchor” on current currency values as their estimates for future values. The actual returns experienced had similar average values to those expected, *but* there was about ten times more variation, which could (and did) lead to significant divergence over time.

Figure 1a: Hedged/Unhedged USD TRI

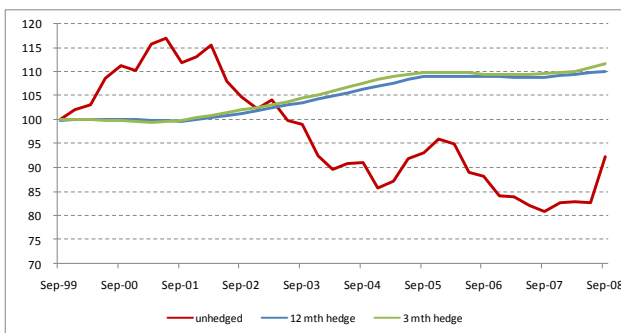
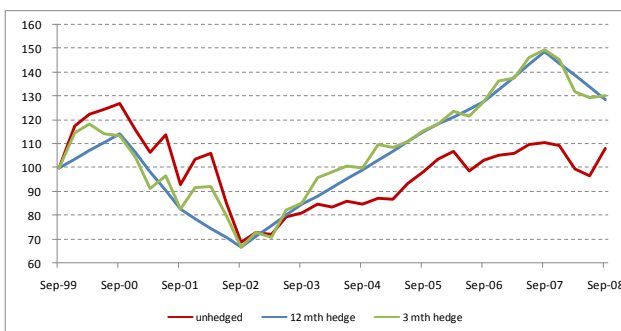


Figure 1a shows the return from holding the US dollar on an unhedged basis and on the basis of hedging back to Sterling on successive 3- or 12-month periods. Figure 1a confirms that the US dollar / Sterling exchange rate has been volatile over the period, and that there were periods (to 2001, in some of 2005 and 2008) where being unhedged was worthwhile. The difference between hedging using 3 and 12 month forward contracts seems slight in this example, and for pronounced periods of time the hedged values are close to constant. *Note: Charts are rebased to 100 at Sept 1999*

Figure 1b: Hedged/Unhedged US Equity TRI



It would be tempting to conclude that just being hedged throughout is always less volatile, but it will often matter what US investment you hold, and whether there is any correlation (positive or negative) with currency. So, as an example, we have considered using US Equities. The cumulative gap shown on the right of Figure 1b has narrowed significantly recently.

Varying between hedged and unhedged equities within the overall period could clearly have added (or lost) further value, given the volatility displayed. So it makes sense to see just how divergent (“wrong”) the actual currency movements were, versus the terms offered by hedging on a rolling 3-month basis.

Figure 1c: Histogram of 3 month divergences

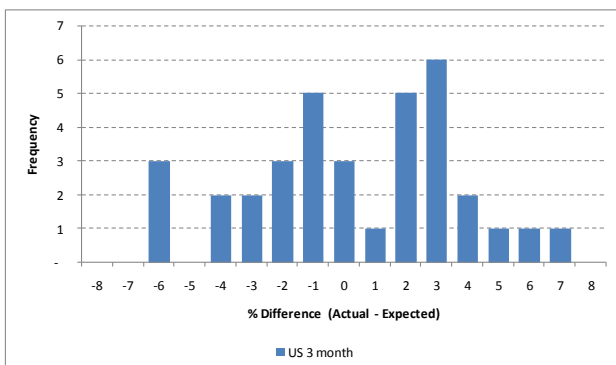


Figure 1c shows a histogram of the difference between the actual 3 month changes in the US\$: £ exchange rate and the hedged rate, over the past nine years. (The equivalent chart for 12-month hedging data is even more widely spread.) Interestingly, the Euro chart is rather more tightly bunched for the 3-month hedge data. So, Figure 1c having now shown the magnitude of the opportunities to gain (and lose!) through tactical switches between hedged and unhedged investments, it is worth noting that how often Trustees can move between the two approaches, without being in breach of the regulatory framework (“no day-to-day management”) appears an untested question so far.



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 September 2008

Asset Class	1 month (%)	3 months (%)	12 months (%)	3 years (% p.a.)	5 years (% p.a.)	10 years (% p.a.)
UK Equities	-13.2	-12.2	-22.3	0.0	7.6	3.7
Overseas Equities	-10.0	-5.8	-15.0	2.1	7.3	4.8
US Equities	-6.6	2.6	-10.1	0.4	4.2	2.8
Europe ex UK Equities	-13.3	-12.5	-20.0	4.8	11.8	5.9
Japan Equities	-8.9	-7.8	-15.4	-4.4	2.8	4.0
Pacific ex Japan Equities	-14.7	-14.8	-27.7	6.7	13.2	11.4
Emerging Markets	-15.5	-18.3	-23.0	8.4	17.4	14.7
UK Long-dated Gilts	-1.4	4.0	5.4	2.4	4.4	4.5
UK Long-dated Corp. Bonds	-6.0	-2.1	-5.7	-1.7	2.1	4.7
UK Over 5 Yrs Index-Linked Gilts	-5.2	-1.1	10.0	6.3	7.0	6.4
High Yield (Global)	-6.8	-0.5	0.1	1.0	3.2	4.1
Overseas Bonds	1.4	9.1	22.3	5.4	3.8	4.8
Property *	-1.1	-3.9	-17.1	3.4	8.5	9.4
Cash	0.5	1.5	6.1	5.5	5.2	5.1
Commodities £-converted	-10.3	-20.2	29.6	0.1	11.7	11.7
Hedge Funds original \$ basis *	-1.4	-4.9	-1.3	7.1	8.5	10.0
Illustrative £-converted version *	7.1	3.0	9.2	6.7	5.3	9.0
Euro relative to Sterling	-2.4	-0.5	12.9	5.0	2.4	-
US \$ relative to Sterling	2.4	11.7	14.9	-0.2	-1.3	-0.4
Price Inflation (RPI) *	0.3	1.0	4.8	4.1	3.6	2.9
Price Inflation (CPI) *	0.6	1.3	4.8	3.0	2.5	1.9
Price Inflation (RPIX) *	0.3	0.9	5.2	3.7	3.1	2.7
Earnings Inflation **	-0.4	1.4	3.6	3.7	3.8	3.9
All Share Capital Growth	-13.4	-13.0	-25.1	-3.3	4.1	0.6
Net Dividend Growth	-0.5	-1.7	19.4	11.7	10.9	5.6
Earnings Growth	-0.5	-5.3	-11.0	8.9	15.3	6.4

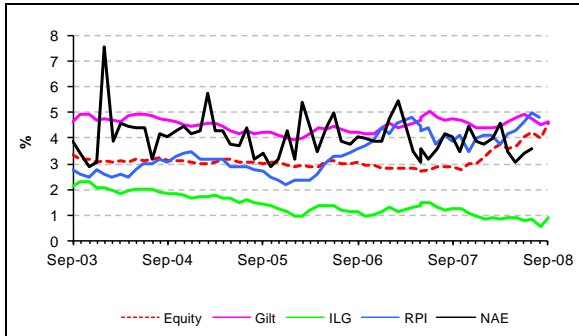
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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.

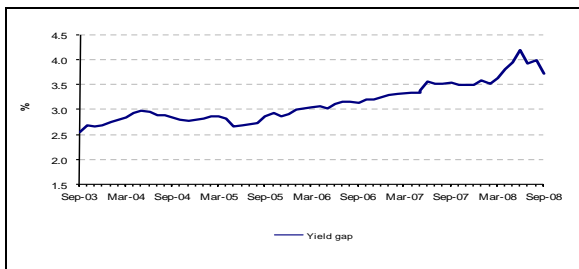


Yields and Yield Gaps

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.

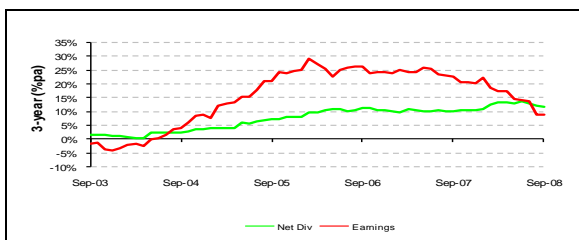
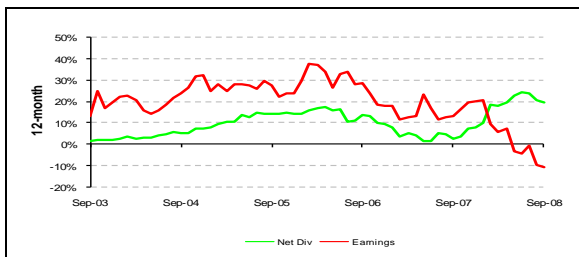


The gap has dropped back from the 4% level, but is still suggesting expectations of prolonged higher longer-term inflation + risk premium for conventional bonds, relative to index-linked.

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]

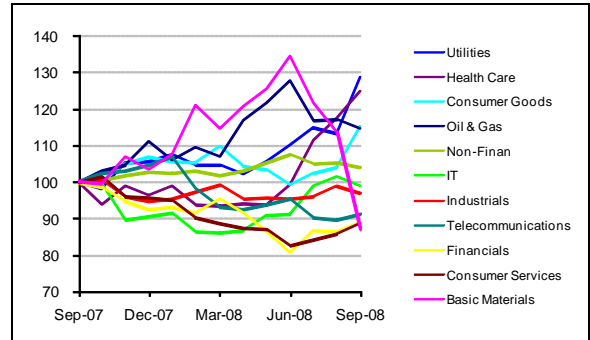
Figure 3: Dividend & Earnings Growth



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



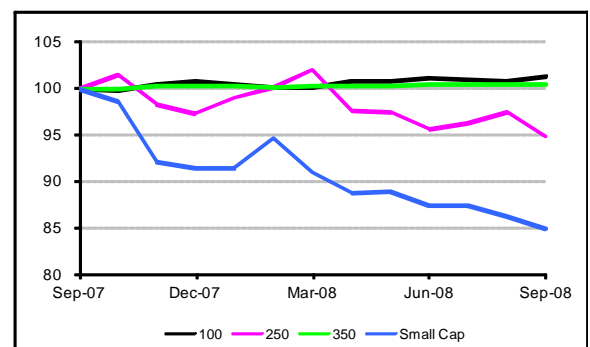
Note: Relative lines' labels for sectors in end-value order

Basic Materials have fallen back *very* sharply this month.

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	-15.3	-21.3	-10.9
Basic Materials	-33.5	-43.2	-32.4
Industrials	-15.0	-10.5	-24.5
Consumer Goods	-4.0	1.9	-10.4
Health Care	-7.9	10.6	-2.9
Consumer Services	-10.2	-5.8	-31.0
Telecommunications	-11.6	-16.0	-29.1
Utilities	-1.5	2.7	0.0
Non-Finan	-14.1	-14.9	-19.0
Financials	-10.6	-3.1	-30.8
IT	-15.3	-4.7	-22.9
All Share	-13.2	-12.2	-22.3

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Small and Mid Cap suffered a little this month.

FRS17 volatility indicator

Now discontinued, but available on request.



Bond market information

Figure 5: £ Non-Gilt Credit Margins

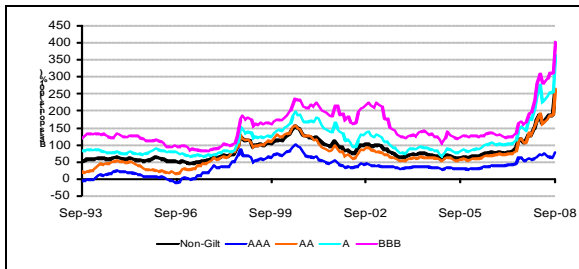


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA (%)	FT 20 yr Gilt Yield (%)	Margin (%)
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
Sep 08	7.17	4.65	2.52

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

Category	Mkt Val (£bn @ Sep 08 & 06, 04)			Weight (%)
Gilts (29)	377	310	259	48.1
Non Gilts (1,115)	407	395	317	51.9
AAA (237)	148	149	121	18.9
AA (236)	70	64	44	8.9
A (403)	127	119	94	16.2
BBB (225)	60	59	53	7.7
Not rated (14)	2	4	5	0.3

Category	Mkt Val (£bn @ Sep 08, 06)		W't (%)	Dur'n (yrs)
Gilts (29)	377	310	48.1	9.2
< 5 Yrs (9)	105	90	13.4	2.6
5-15 Yrs (9)	119	115	15.2	7.1
> 15 Yrs (11)	153	105	19.5	15.4
Non Gilts (1,115)	407	395	51.9	6.9
< 5 Yrs (331)	136	111	17.4	2.5
5-15 Yrs (475)	156	153	19.9	6.9
> 15 Yrs (309)	115	131	14.7	12.0

£ Gilt Market Issuance and Coverage

- £2.25bn of 4¼% 2049 (1.73x, yield 4.37%, new)
- £3.5bn of 4½% 2013 (2.13x, 4.42%, prev June 08)
- £2.5bn of 4½% 2019 (2.19x, 4.73%, new)
- £0.45bn of ILG 1¼% 2055 (2.28x, r.y. 0.61%, June 08)

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

Category	Mkt Val (€bn @ Sep 08)	Weight (%)
Sovereigns (238)	3,176	59.7
Non Sovereigns	2,140	40.3
AAA (629)	1,095	20.6
AA (416)	460	8.6
A (527)	409	7.7
BBB (233)	177	3.3

Category	Mkt Val (€bn @ Sep 08)	Weight (%)
1 – 3 Yrs (575)	1,472	27.7
3 – 5 Yrs (500)	1,179	22.2
5 – 7 Yrs (362)	739	13.9
7 – 10 Yrs (402)	956	18.0
10+ Yrs (204)	970	18.2

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Sep 08 & 06)		W't (%)	Dur'n (yrs)
Gilts (13)	170	125	90.9	13.4
< 5 Yrs (2)	33	21	17.6	3.8
5 – 15 Yrs (4)	59	58	31.6	9.0
> 15 Yrs (7)	78	46	41.7	20.9
Non Gilts (56)	17	13	9.1	15.4

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

Month End	US (%)	Euro (%)	Sterling (%)
May 08	9.39	9.81	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
Sep 08	12.55	15.55	17.16

Sources: Barclays Capital, DMO, iBoxx, J&A, MLX

