



Investment Update August 2009

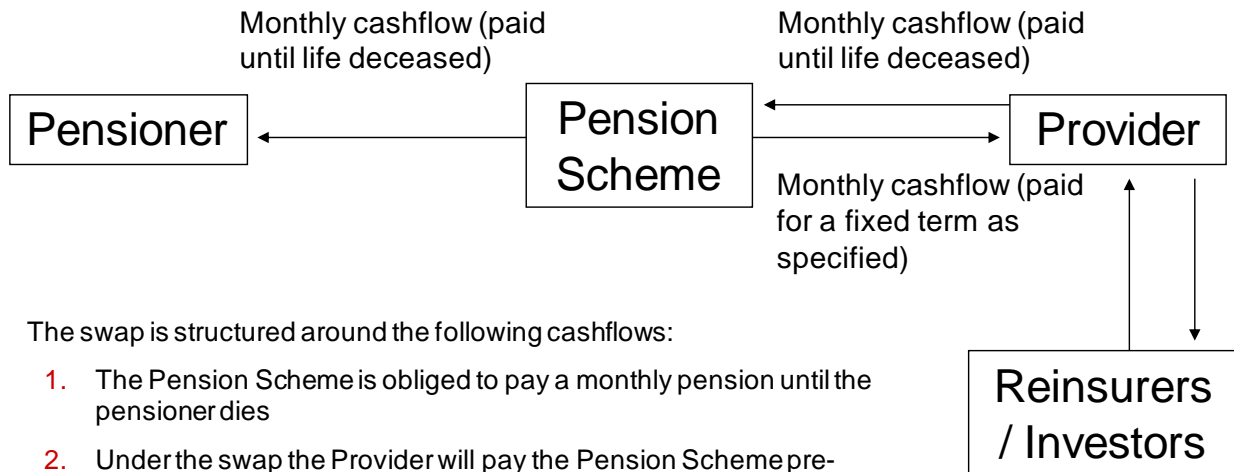
Investment Headlines & Comment

- An unintended consequence of the prospect of the **Bank of England** charging banks to deposit funds - they will buy short gilts instead and hence trigger record low **index-linked gilt** yields.
- This has led to remarkable 1-month returns in long **gilts** and **corporates**. Meanwhile, equity markets had another strong month, in the belief that the worst of the recession is over.
- **Insight** is being broken up by **Lloyds Banking Group** - the £80bn **LDI** (and external funds) business is going to **BNY Mellon**, and the £42bn of life company funds go to **Scottish Widows**.

Feature Section

This month's feature is on longevity swaps. Hitherto, pension schemes could buy annuities (removing investment *and* mortality risk) or could invest in suitable bonds (removing investment risk, but leaving the mortality risk in place). Longevity swaps are where you can remove the mortality risk yet retain scope for as much investment risk as you wish. We are grateful to solicitors Pinsent Masons for their input in this two-part article. Pinsents act for schemes on the complex documentation required for making investments in this area, including Devonport Royal Dockyard Pension Scheme - the first UK pension scheme to enter into a longevity swap contract (at the end of June 2009). The easiest way to describe what is going on is in a diagram, such as in Figure 1 (*Source: Pinsent Masons*).

Figure 1: A Longevity Swap in action



- The swap is structured around the following cashflows:
 1. The Pension Scheme is obliged to pay a monthly pension until the pensioner dies
 2. Under the swap the Provider will pay the Pension Scheme pre-determined monthly amounts (the “floating leg”) until the pensioner dies
 3. The Pension Scheme pays the Provider pre-determined monthly amounts (the “fixed leg”) for a pre-determined time
- Cashflows 2 and 3 are netted against each other

Trustees will naturally be concerned that the security offered by the counterparty remains strong during the duration of the contract. This is addressed by the posting of collateral on a regular basis by whichever of the parties is expected to have to make net payments in the future. So, for example, if it looks as though the contract is becoming more valuable for the trustees because pensioners are living longer than expected, the counterparty will be required to post collateral in favour of the trustees. From the perspective of the pensioners, nothing has changed. From the perspective of the pension scheme trustees, the freedom of investment of their scheme assets is only reduced if they have to post collateral, unlike for an annuity purchase where all freedom has been removed.

In next month's concluding part to this article, we move onto some interesting practical issues. If the counterparty defaults, how effective is the collateral? How much risk can a scheme be hit for in the period between the counterparty defaulting and a new counterparty being introduced? How do you go about unwinding the swap, if you get to the point where the scheme is being wound up and a “conventional” annuity purchase is thus required? And if there are few counterparties in the market, is there a risk that Trustees enter into swaps on unduly adverse terms because they are being pressured to “remove risk at any price”? [Ed: Now how's that for a cliffhanger ending this month?!]



Asset Returns and Financial Measures [in Sterling unless marked otherwise]

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 that.

[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 2009

Asset Class	1 month (%)	3 months (%)	12 months (%)	3 years (% p.a.)	5 years (% p.a.)	10 years (% p.a.)
UK Equities	7.7	13.1	-8.2	-2.1	6.3	1.7
Overseas Equities	5.4	11.1	-4.7	2.2	7.2	1.8
US Equities	5.4	10.6	-8.1	-0.3	3.0	-0.8
Europe ex UK Equities	8.8	14.5	-6.9	2.2	10.9	4.2
Japan Equities	5.8	9.2	1.0	-3.2	4.0	-1.1
Pacific ex Japan Equities	1.4	11.8	7.9	11.8	16.9	8.8
Emerging Markets	1.4	8.3	1.1	11.0	19.4	10.3
UK Long-dated Gilts	7.3	8.5	11.3	4.9	6.2	5.2
UK Long-dated Corp. Bonds	8.2	15.9	10.4	2.3	4.8	5.7
UK Over 5 Yrs Index-Linked Gilts	3.6	5.0	-2.3	5.1	6.4	6.0
High Yield (Global)	4.2	11.8	19.6	9.7	7.9	5.6
Overseas Bonds	3.7	2.5	24.3	14.8	8.8	6.6
Property *	0.6	-0.5	-24.1	-10.9	0.1	5.5
Cash	0.1	0.3	2.7	4.8	4.8	4.8
Commodities £-converted	-0.7	-2.4	-45.7	-9.6	-2.5	4.9
Hedge Funds original \$ basis *	2.5	8.0	-5.7	2.2	5.8	7.2
Illustrative £-converted version *	1.8	-3.5	12.7	6.3	7.7	6.9
Euro relative to Sterling	2.9	0.3	9.1	9.4	5.4	3.0
US \$ relative to Sterling	1.7	-1.0	11.9	5.3	2.0	-0.1
Japanese Yen relative to Sterling	4.4	1.8	30.9	13.8	5.5	1.5
Price Inflation (RPI) *	0.0	0.9	-1.4	2.4	2.7	2.6
Price Inflation (CPI) *	-0.1	0.7	1.7	2.7	2.5	1.9
Price Inflation (RPIX) *	0.0	0.9	1.2	3.1	3.0	2.6
Earnings Inflation **	1.0	-6.1	1.7	2.8	3.4	3.7
All Share Capital Growth	7.1	11.9	-12.1	-5.7	2.6	-1.5
Net Dividend Growth	-9.3	-14.8	-23.7	-1.2	4.1	2.6
Earnings Growth	-14.4	-28.8	-35.3	-13.1	1.7	3.4

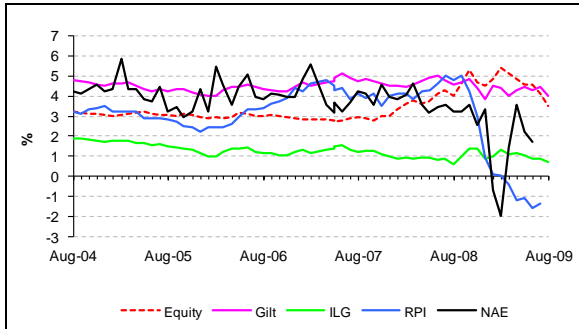
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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.

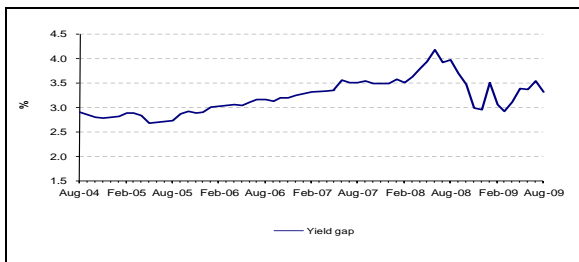


Yields and Yield Gaps

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.

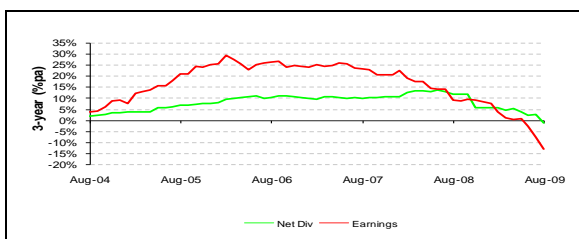
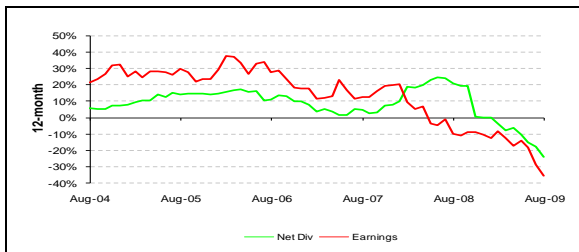


The gap has dipped below expectations of about 3.5% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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]

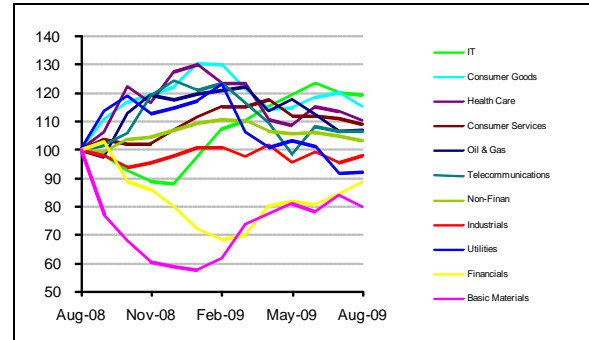
Figure 3: Dividend & Earnings Growth



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



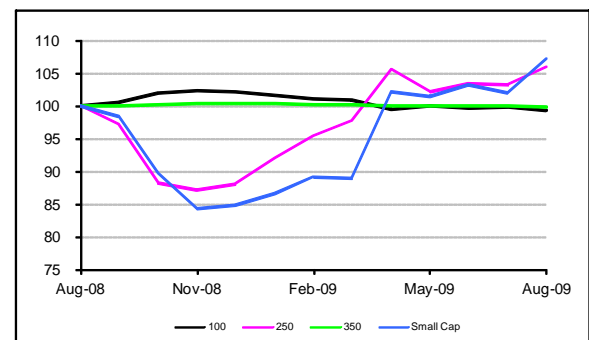
Note: Relative lines' labels for sectors in end-value order

A slight reduction in the rolling 12-month sector dispersion this month (down from 45% to 40%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	8.2	2.9	-1.6
Basic Materials	2.3	10.8	-27.0
Industrials	10.3	15.8	-10.1
Consumer Goods	3.3	13.7	5.8
Health Care	4.6	15.0	1.3
Consumer Services	5.9	10.3	0.1
Telecommunications	7.7	22.5	-2.1
Utilities	8.0	0.7	-15.4
Non-Finan	6.0	10.3	-5.3
Financials	13.1	22.5	-18.7
IT	7.2	13.1	9.6
All Share	7.7	13.1	-8.2

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



The relative rally in Mid and Small Cap has continued.

FRS17 volatility indicator

Now discontinued, but available on request.



Bond market information

Figure 5: £ Non-Gilt Credit Margins

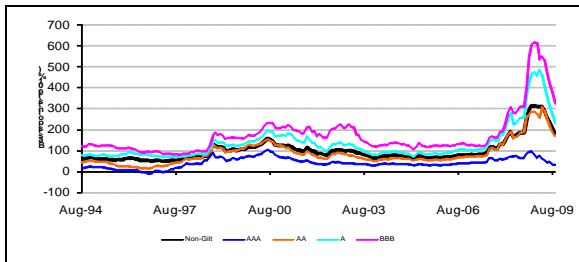


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
Mar 09	6.58	4.00	2.58
Apr 09	6.83	4.23	2.60
May 09	6.52	4.40	2.12
Jun 09	6.11	4.26	1.85
Jul 09	5.94	4.41	1.53
Aug 09	5.34	4.00	1.34

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

Category	Mkt Val (£bn @ Aug 09 & 07, 05)			Weight (%)
Gilts (33)	650	316	306	58.1
Non Gilts (1,052)	469	420	366	41.9
AAA (181)	149	156	141	13.3
AA (191)	69	63	56	6.2
A (397)	156	130	111	14.0
BBB (268)	92	68	53	8.3
Not rated (15)	3	3	4	0.2

Category	Mkt Val (£bn @ Aug 09, 07)		W't (%)	Dur'n (yrs)
Gilts (33)	650	316	58.1	9.2
< 5 Yrs (9)	165	87	14.8	2.7
5-15 Yrs (11)	234	107	20.9	6.9
> 15 Yrs (13)	250	122	22.4	15.8
Non Gilts (1,052)	469	420	41.9	7.1
< 5 Yrs (302)	154	125	13.7	2.4
5-15 Yrs (458)	183	167	16.3	7.0
> 15 Yrs (292)	133	128	11.9	12.7

£ Gilt Market “main” Issuance

- £3.84bn 3¾% 2019 (1.89x, 3.93%, Jul 09)
- £2.75bn 4¼% 2027 (1.88x, 4.55%, Jan 09)
- £1.13bn ILG 1¼% 2032 (1.75x, r.y 0.81%, May 09)
- £0.45bn ILG ¾% 2047 (3.28x, r.y 0.64%, Jun 09)

Tables 2d, 2e: € Market Size and Maturity (Aug 09)

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (261)	3,759	57.6
Non Sovereigns	2,763	42.4
AAA (645)	1,293	19.8
AA (387)	545	8.4
A (642)	641	9.8
BBB (348)	285	4.4

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (686)	1,856	28.5
3 – 5 Yrs (678)	1,567	24.0
5 – 7 Yrs (377)	879	13.5
7 – 10 Yrs (337)	1,097	16.8
10+ Yrs (205)	1,123	17.2

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Aug 09 & 07)		W't (%)	Dur'n (yrs)
Gilts (15)	199	143	90.9	14.1
< 5 Yrs (2)	34	21	15.5	3.0
5 – 15 Yrs (5)	81	62	37.0	9.4
> 15 Yrs (8)	84	59	38.4	23.2
Non Gilts (50)	20	15	9.1	17.0

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

Month End	US (%)	Euro (%)	Sterling (%)
May 09	11.66	16.46	22.69
Jun 09	11.20	15.65	19.58
Jul 09	10.04	12.24	16.27
Aug 09	9.83	11.43	15.16

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

