



Investment Update September 2009

Investment Headlines & Comment

- A massive £5bn syndication of the new **ILG 2050**, at a real yield of 0.54%, adding nearly a year to long ILG index duration.
- One of the strongest quarters ever for most **equity markets**, but 12 months results were not unusual (the background *was* remarkable).
- Four of **Scottish Widows'** bond team are off to **Alliance Trust**. Also, their Equities CIO and UK Equities head left this month.

Feature Section

This month's feature is the second part of our review of longevity swaps. Last month we explained their basic purpose and structure, and this month we look at some of the practical issues and concerns that arise, again assisted by Pinsent Masons' contribution. One initial aside – a longevity swap is a derivative, using ISDA documentation. An alternative method of longevity hedging is by using an insured product (with the security offered through the FSA, capital ratios imposed on insurers etc). That has similarities to the derivatives route but some significant differences in how security is addressed for trustees. Our focus is longevity hedging using the derivative route.

If a counterparty defaults, how effective is the collateral? The amount of collateral posted at any time needs to track as closely as possible the amount that would be payable if the contract were to be terminated – so the frequency of valuations needs to be appropriate and the contract valuation method needs to reflect, as far as possible, the approach that would be expected to be taken in the market generally in valuing the cost of replacement longevity swap contracts. Under-collateralisation risk is greater for derivative contracts whose underlying variables are particularly volatile (where, for example, a sudden change in value occurs but a party defaults before posting the required increase in collateral). The value of a longevity swap contract is likely to be more stable because the underlying variable (longevity) is less susceptible to sudden changes (save, in extreme cases – for example, a miracle cure being discovered). Potential volatility in the value of the posted collateral can also pose a practical risk – if the value of the collateral held falls significantly just before the contract is terminated but the contract value remains steady then the net termination payment would increase. For this reason parties tend only to accept those types of collateral with fairly stable values. *J&A comment:* This seems reasonable enough so far, provided everything is set out clearly in the original contract.

How much risk can a scheme be hit for in the period between the counterparty defaulting and a new counterparty being introduced? This again relies on the general stability in the value of a longevity swap contract. *J&A comment:* So, it is really a question of whether issuers are writing these contracts at the time that a new contract is being sourced. If they are, then there is relatively little risk involved, but if they are not, then there is a problem.

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? If an insurance buy-out is to be effected, then one possibility is to transfer the contract to the insurer. Such a transfer is likely to require the consent of the counterparty as it may have internal restrictions (which could change over time) as to the identities of those third parties with whom it can contract. Even if the proposed transferee is in principle acceptable, the counterparty's existing credit exposure to that party at the relevant time may preclude such a transfer. Another option would be to seek to unwind the contract by approaching the counterparty to request a quote of the amount which would then be payable by one party to the other to terminate the contract. Whilst the counterparty is unlikely to agree to be contractually bound to provide a quote, in practice (except in unusual circumstances) most financial institutions tend to be willing to do so. *J&A comment:* This doesn't feel as watertight and comforting as most Trustees would want. There is no guarantee either unwinding route would work!

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"? Whilst the market in longevity hedging remains in its infancy, those counterparties with products available appear to have a degree of monopoly pricing. However, they are competing against more traditional insurance solutions to longevity risk and this helps to regulate pricing. If the pricing of the fixed leg exceeds the scheme's technical provisions then the trustees should consider seeking additional contributions from the sponsoring employer to cover the 'funding gap' – if the employer agrees to do so then pricing becomes less of an issue for trustees and more of an issue for the sponsoring employer. *J&A comment:* This shift to the employer's needs is fair enough, but if they follow the "hedge anything that moves" route too doggedly, then it feels dangerously like a fee-generating opportunity for banks and consultants.



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 30 September 2009

Asset Class	1 month (%)	3 months (%)	12 months (%)	3 years (% p.a.)	5 years (% p.a.)	10 years (% p.a.)
UK Equities	4.7	22.4	10.8	-1.1	6.7	2.5
Overseas Equities	6.8	21.7	13.0	3.3	8.3	2.8
US Equities	5.8	19.2	4.1	0.1	4.1	0.3
Europe ex UK Equities	7.8	29.6	15.8	3.7	11.8	5.3
Japan Equities	-0.1	9.3	10.8	-3.3	4.6	-1.5
Pacific ex Japan Equities	11.5	26.0	41.0	14.5	18.6	10.7
Emerging Markets	11.2	24.7	33.0	14.1	20.6	12.2
UK Long-dated Gilts	0.4	5.9	13.3	4.8	6.1	5.6
UK Long-dated Corp. Bonds	1.2	11.7	18.9	2.6	4.8	6.2
UK Over 5 Yrs Index-Linked Gilts	0.4	3.0	3.5	5.3	6.3	6.0
High Yield (Global)	8.6	20.1	39.4	11.7	9.4	6.8
Overseas Bonds	4.5	9.5	28.1	15.9	9.6	7.1
Property *	0.9	1.3	-22.6	-11.0	0.0	5.5
Cash	0.0	0.2	2.3	4.7	4.8	4.8
Commodities £-converted	2.1	1.2	-38.2	-6.0	-4.4	4.8
Hedge Funds original \$ basis *	1.3	4.1	-3.0	2.3	6.0	7.3
Illustrative £-converted version *	3.1	3.1	8.6	7.7	8.2	7.2
Euro relative to Sterling	3.8	7.3	16.0	10.5	5.9	3.5
US \$ relative to Sterling	1.9	3.0	11.4	5.4	2.5	0.3
Japanese Yen relative to Sterling	5.6	11.0	32.1	15.5	6.8	2.0
Price Inflation (RPI) *	0.5	0.8	-1.3	2.5	2.7	2.6
Price Inflation (CPI) *	0.5	0.6	1.5	2.7	2.6	1.9
Price Inflation (RPIX) *	0.5	0.8	1.4	3.1	3.0	2.6
Earnings Inflation **	-1.5	-1.2	0.9	2.7	3.3	3.5
All Share Capital Growth	4.5	21.3	6.1	-4.8	3.0	-0.7
Net Dividend Growth	0.0	-11.4	-23.4	-2.0	4.1	2.6
Earnings Growth	-1.8	-26.1	-36.1	-13.8	1.0	3.0

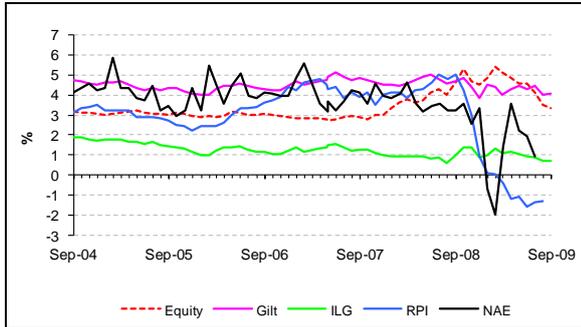
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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.

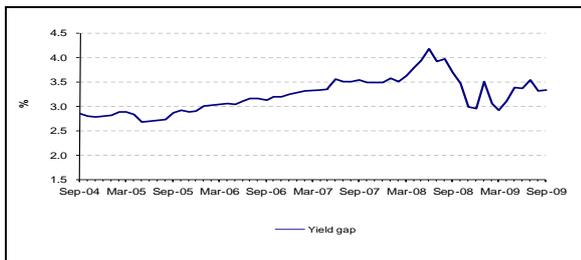


Yields and Yield Gaps

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.

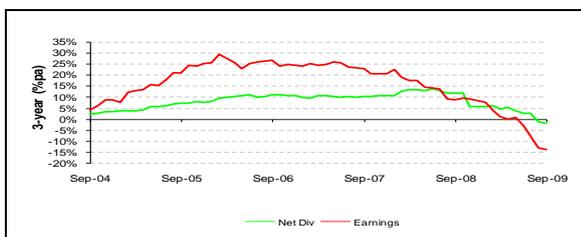
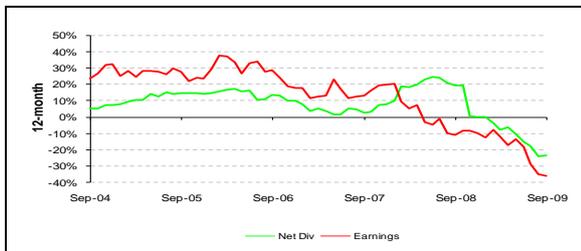


The gap has stayed below expectations of about 3.5% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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]

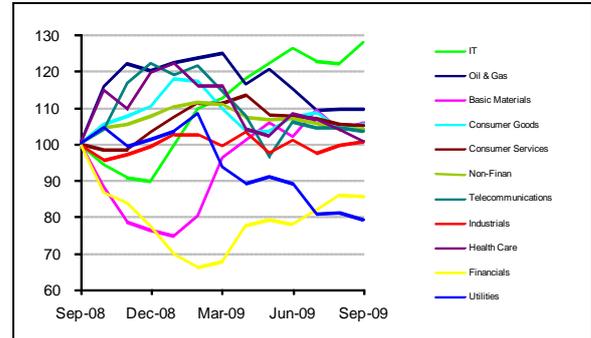
Figure 3: Dividend & Earnings Growth



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



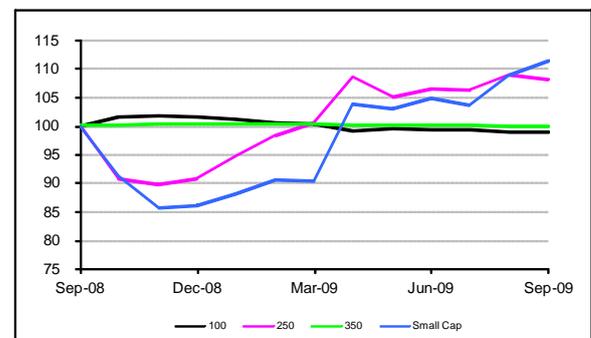
Note: Relative lines' labels for sectors in end-value order

A slight increase in the rolling 12-month sector dispersion this month (up from 40% to 49%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	4.5	16.4	21.3
Basic Materials	6.8	27.1	17.3
Industrials	5.8	22.1	11.8
Consumer Goods	6.2	20.5	17.0
Health Care	1.5	13.7	11.6
Consumer Services	4.5	19.2	16.5
Telecommunications	3.8	19.5	15.0
Utilities	2.3	8.7	-12.1
Non-Finan	4.8	18.9	15.5
Financials	4.5	34.3	-5.0
IT	9.6	24.0	41.9
All Share	4.7	22.4	10.8

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



The relative rally in Small Cap has continued, but Mid Cap faltered slightly.

FRS17 volatility indicator

Now discontinued, but available on request.



Bond market information

Figure 5: £ Non-Gilt Credit Margins

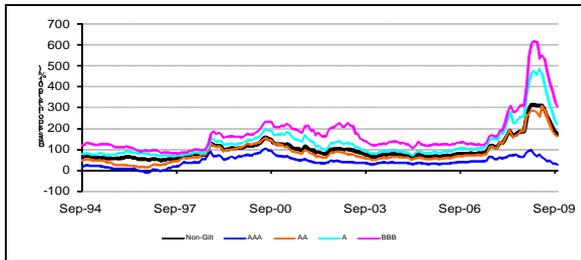


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
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
Sep 09	5.38	4.01	1.37

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

Category	Mkt Val (£bn @ Sep 09 & 07, 05)			Weight (%)
Gilts (33)	668	313	303	58.1
Non Gilts (1,058)	481	421	366	41.9
AAA (181)	150	157	141	13.1
AA (183)	66	63	56	5.8
A (408)	165	130	112	14.3
BBB (270)	97	68	53	8.4
Not rated (16)	3	3	4	0.2

Category	Mkt Val (£bn @ Sep 09, 07)		W't (%)	Dur'n (yrs)
Gilts (33)	668	313	58.1	9.1
< 5 Yrs (10)	201	87	17.5	2.9
5-15 Yrs (10)	213	106	18.6	7.2
> 15 Yrs (13)	254	120	22.1	15.7
Non Gilts (1,058)	481	421	41.9	7.1
< 5 Yrs (299)	153	126	13.4	2.4
5-15 Yrs (465)	192	167	16.7	7.0
> 15 Yrs (294)	136	128	11.8	12.7

£ Gilt Market “main” Issuance

- £5.1bn 5¼% 2012 (2.05x, 1.95%, prev Feb 09)
- £5.77bn 2¼% 2014 (1.84x, 2.66%, Jul 09)
- £4.13bn 3¾% 2019 (2.15x, 3.78%, Aug 09)
- £4.05bn 4% 2022 (1.72x, 3.89%, Jun 09)
- £1bn 6% 2028 (2.13x, 3.94%, Nov 99, yes, 99)
- £2.30bn 4¼% 2039 (1.62x, 4.17%, Jul 09)
- £5bn ILG ½% 2050 (1.84x, r.y 0.54%, new)

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

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (260)	3,782	57.5
Non Sovereigns	2,792	42.5
AAA (641)	1,303	19.8
AA (390)	558	8.5
A (628)	634	9.7
BBB (357)	297	4.5

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (680)	1,854	28.2
3 – 5 Yrs (677)	1,614	24.6
5 – 7 Yrs (378)	877	13.4
7 – 10 Yrs (338)	1,092	16.6
10+ Yrs (203)	1,137	17.3

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Sep 09 & 07)		W't (%)	Dur'n (yrs)
Gilts (16)	204	143	90.7	14.7
< 5 Yrs (2)	34	22	15.1	2.9
5 – 15 Yrs (5)	82	63	36.4	9.3
> 15 Yrs (9)	89	59	39.6	24.1
Non Gilts (50)	21	15	9.3	17.1

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

Month End	US (%)	Euro (%)	Sterling (%)
Jun 09	11.20	15.65	19.58
Jul 09	10.04	12.24	16.27
Aug 09	9.83	11.43	15.16
Sep 09	8.91	9.95	13.33

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

