JAGGER & ASSOCIATES

Investment Update
January 2010

Investment Headlines & Comment

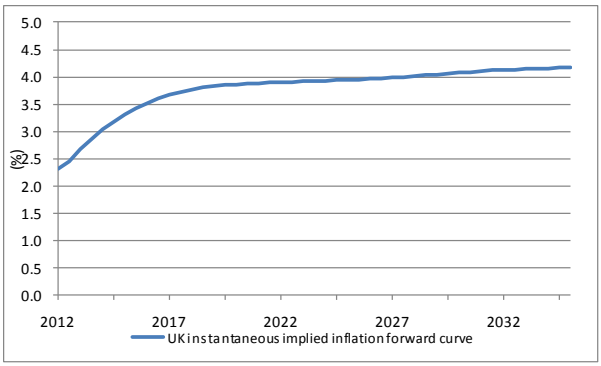
- **Euro bond yields** have speeded up their divergence this month – Greek 10-year yields are now over 3.7% higher than German ones.
- **Commodities** suffered this month but **UK Property** continued with its rally. Perhaps diversification rules are beginning to hold again?
- **1-year RPI inflation** jumped significantly this month, partly as the fall in Dec 08 dropped out of the analysis. (Figure 2 on page 3.)

Feature Section

This month's feature considers whether investors should now cease to regard gilts as the low-risk investment they are conventionally portrayed. In particular, should pension fund trustees now go against the conventional wisdom dinned into them over many years that the more mature the scheme, the more they should be holding gilts? Or must they hold onto them to be "safe"?

High gilt issuance is likely to continue as the Pre-Budget Report published in December 2009 indicated an illustrative financing requirement for the next 4 years of £213bn, £195bn, £162bn, and £148bn (although a major change in Government spending may reduce these values). On that basis alone, it is tempting to conclude that gilts are an unappealing investment, even though they may correlate with liabilities, and corporate bonds would be a logical initial alternative (possibly using all-dated or short-dated bonds, rather than going for longer-dated ones, even for cases with longer term liabilities). The credit margins we show each month in Figure 5 (page 4) relate to sterling-denominated corporate bonds, which can be issued by overseas as well as sterling borrowers. So, the ratings do not just relate to bonds from UK companies. It could be possible for future contractions in credit margins to counter future rises in gilt yields, to leave the actual (total) return from corporates fairly stable. We consider this further later in this article.

Figure 1: Year-by-year RPI inflation



Source: Bank of England

As noted by the Governor in discussing the last Bank of England inflation report, at some point monetary policy will clearly be tightened, possibly through asset sales, and/or the raising of interest rates. It seems likely that a sale of the Bank of England's large gilt portfolio would have a negative impact on gilt prices, leading to increases in yields (and negative returns). Figure 1 shows the current implied inflation rate factored in to nominal interest rates ('forward' implied inflation rates can be thought of as the average rate of inflation expected at each point). The chart shows that the expected yearly future inflation stabilises at around 4%, and is lower than a "LPI 5%" cap which may apply for some pension funds' liabilities' increases. We suspect the rates shown in Figure 1a understate the actual year-to-year volatility in inflation that would be experienced.

In May 2009, the rating agency Standard & Poor's put the UK's AAA-rating on a negative outlook and threatened to lower it depending on the Treasury's stance after the summer general election. To see the effect a downgrading may have, in December 2008 Greek debt was downgraded, and in June 2009 Irish debt was downgraded. Prior to June 2008 the spreads between UK and Greek debt, and UK and Irish debt, were *negative* reflecting the convergence of non-UK yields in the Eurozone. By December 2008 the UK-Greek spread had increased to +2.0%, and by June 2009 the UK-Irish spread had increased to +1.9%, however in both cases the increases were gradual as the market took time to respond to the increased probability of default. To be fair, some of the Greek margin stems from concerns over the reliability of government book-keeping, which should not be a problem in the UK, but the general point still stands.

So, the gilt yield rise from a UK downgrade could well swamp the credit margin contraction. Some international bond managers (notably Pimco) have expressed bearishness on the UK in very emotive terms. If investors are particularly concerned by the possibility and impact of a UK rerating then they could invest in an overseas government or corporate bond fund. In both cases they could hedge the currency exposure back to Sterling, although there is the separate question of whether Sterling would weaken in a downgrade, and by how much. However, we think it will still take Trustees of mature schemes a lot of nerve to go against the conventional wisdom of holding gilts in respect of their associated liabilities, and likewise for them to consider the duration mismatch of holding short-dated bonds.

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 January 2010

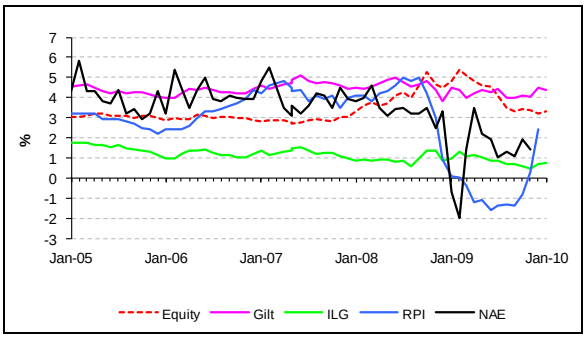
Asset Class	1 month (%)	3 months (%)	12 months (%)	3 years (% p.a.)	5 years (% p.a.)	10 years (% p.a.)
UK Equities	-3.6	3.6	33.2	-2.5	5.4	2.1
Overseas Equities	-3.5	4.7	28.2	1.5	7.2	1.6
US Equities	-2.6	7.4	20.6	-0.4	4.1	-0.5
Europe ex UK Equities	**-5.3**	0.6	33.7	-0.4	8.6	3.7
Japan Equities	2.7	4.3	4.3	-3.8	3.1	**-3.0**
Pacific ex Japan Equities	**-5.3**	3.1	59.6	10.8	16.1	9.2
Emerging Markets	-4.8	5.3	**62.6**	11.1	**18.3**	**9.6**
UK Long-dated Gilts	1.0	**-2.7**	6.1	4.8	4.6	5.0
UK Long-dated Corp. Bonds	2.4	1.2	21.5	3.3	3.7	6.1
UK Over 5 Yrs Index-Linked Gilts	-0.0	-1.3	7.3	6.4	6.0	5.8
High Yield (Global)	2.2	7.9	40.9	13.9	10.7	7.3
Overseas Bonds	1.3	1.6	**-4.5**	**17.0**	8.7	7.2
Property *	**3.6**	**9.4**	2.2	**-9.2**	**1.0**	6.1
Cash	0.1	0.2	1.1	4.2	4.5	4.6
Commodities £-converted	-7.1	-3.0	3.3	-2.4	-2.7	3.6
Hedge Funds original $ basis *	1.3	2.7	20.1	2.2	5.7	6.4
Illustrative £-converted version *	2.9	1.6	8.5	9.0	9.4	6.4
Euro relative to Sterling	-2.4	-3.1	-2.4	9.3	4.6	3.7
US $ relative to Sterling	0.8	2.9	-10.0	7.0	3.3	0.1
Japanese Yen relative to Sterling	3.4	2.7	-10.9	17.7	6.1	1.8
Price Inflation (RPI) *	0.6	1.3	2.4	2.5	2.8	2.7
Price Inflation (CPI) *	0.5	1.0	2.8	2.7	2.6	1.9
Price Inflation (RPIX) *	0.6	1.3	3.8	3.2	3.1	2.7
Earnings Inflation **	0.1	0.7	1.4	2.8	3.1	3.5
All Share Capital Growth	-3.6	2.9	28.0	-6.1	1.7	-1.1
Net Dividend Growth	0.6	1.1	-10.9	-0.8	3.8	2.6
Earnings Growth	0.2	0.5	-39.1	-13.7	-0.4	2.5

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

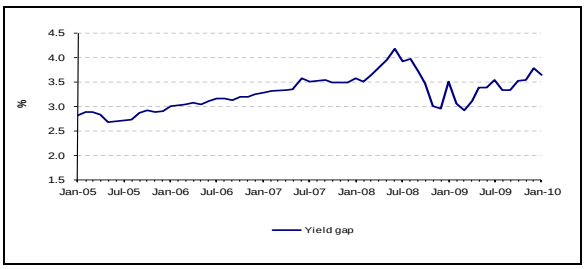
- *UK Equities (incl. dividends and earnings) – FT-A All Share.*
- *Overseas Equities (incl. regions) – blend of FT All-World / World subindices*
- *Emerging Markets from MSCI US $ based total return index (overall Index to 31 Oct 2001, Free Index from 1 Nov 2001 to take account of foreign investment restrictions), conversion to UK £ by J&A.*
- *UK Bonds – FT-A indices (Gilts Over 15 Years, ILG Over 5 Years)*
- *UK Corporate Bonds – iBoxx 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.

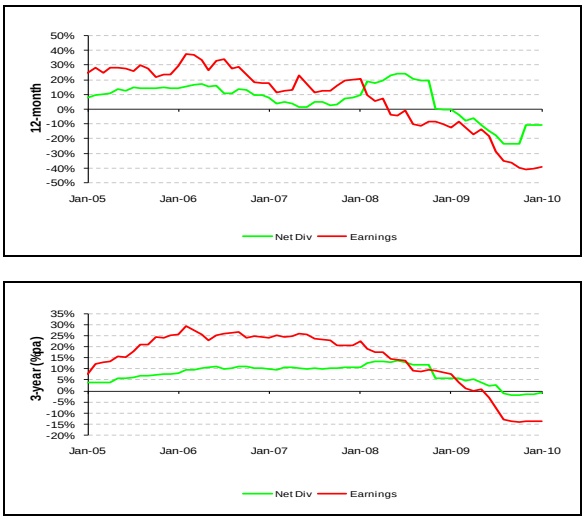


The gap gives expectations over 3.5% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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*]

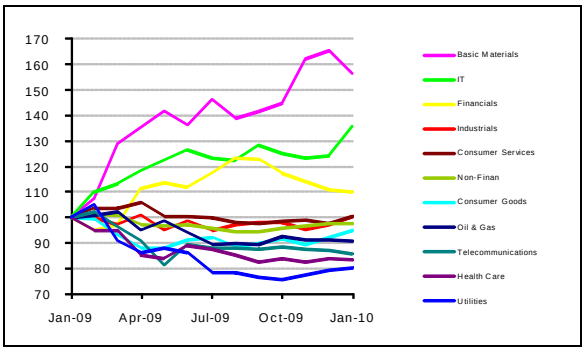
Figure 3: Dividend & Earnings Growth



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



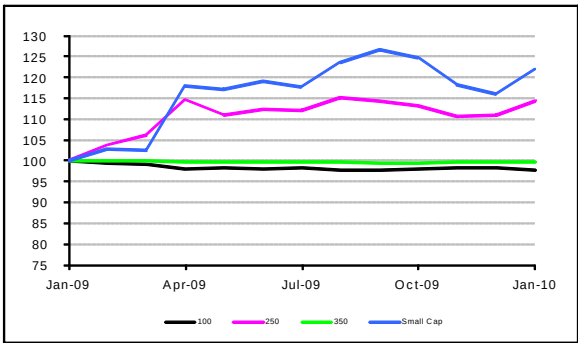
Note: Relative lines' labels for sectors in end-value order

A decrease this month in the rolling 12-month sector dispersion (down from 81% to 76%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	-3.9	1.8	20.8
Basic Materials	-8.9	11.8	108.2
Industrials	-0.8	5.6	33.3
Consumer Goods	-0.8	7.1	26.1
Health Care	-4.0	2.8	10.9
Consumer Services	-1.0	5.3	33.3
Telecommunications	-4.9	0.3	14.2
Utilities	-2.1	10.4	7.0
Non-Finan	-3.4	5.6	30.1
Financials	-4.2	-2.7	46.5
IT	5.4	12.3	80.4
All Share	-3.6	3.6	33.2

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Mid and Small Cap rallied in relative terms this month.

FRS17 volatility indicator

Now discontinued, but available on request.

Bond market information

Figure 5: £ Non-Gilt Credit Margins

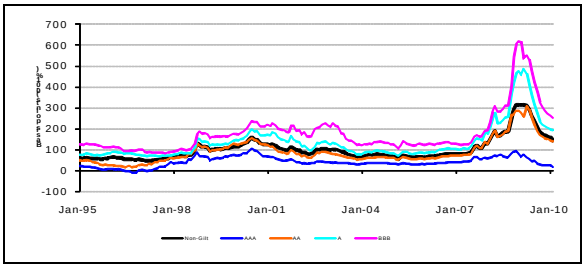


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
Aug 09	5.34	4.00	1.34
Sep 09	5.38	4.01	1.37
Oct 09	5.45	4.08	1.37
Nov 09	5.34	4.03	1.31
Dec 09	5.58	4.46	1.12
Jan 10	**5.46**	**4.38**	**1.08**

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

Category	Mkt Val (£bn @ Jan 10 & 08, 06)			Weight (%)
Gilts (34)	697	347	317	59.5
Non Gilts (1,051)	475	416	373	40.5
AAA (190)	149	155	142	12.7
AA (198)	756	61	58	6.5
A (404)	167	131	111	14.3
BBB (259)	83	67	58	7.1

Category	Mkt Val (£bn @ Jan 10, 08)		W't (%)	Dur'n (yrs)
Gilts (34)	697	347	59.5	8.8
< 5 Yrs (9)	205	95	17.5	2.7
5–15 Yrs (11)	236	115	20.2	6.9
> 15 Yrs (14)	256	137	21.9	15.5
Non Gilts (1,051)	475	416	40.5	7.2
< 5 Yrs (289)	147	130	12.5	2.4
5–15 Yrs (478)	198	161	16.9	7.0
> 15 Yrs (284)	130	125	11.1	12.8

£ Gilt Market "main" Issuance

- £4.40bn 2¾% 2015 (2.68x, 3.08%, Dec 09)
- £3.58bn 3¾% 2019 (2.38x, 4.09%, Dec 09)
- £2.43bn 4¼% 2049 (1.81x, 4.34%, Jun 09)
- £0.60bn ILG 1¼% 2017 (3.32x, r.y 0.56%, Apr 08)
- £3.50bn ILG $^{5}/_{8}$% 2040 (1.29x, r.y 0.71%, new)

Tables 2d, 2e: € Market Size and Maturity (Jan 10)

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (263)	3,864	57.5
Non Sovereigns	2,859	42.5
AAA (650)	1,294	19.2
AA (387)	559	8.3
A (646)	683	10.2
BBB (384)	323	4.8

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (687)	1,882	28.0
3 – 5 Yrs (701)	1,641	24.4
5 – 7 Yrs (392)	917	13.6
7 – 10 Yrs (337)	1,133	16.9
10+ Yrs (213)	1,150	17.1

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Jan 10 & 08)		W't (%)	Dur'n (yrs)
Gilts (16)	211	161	90.6	14.4
< 5 Yrs (2)	35	23	15.0	2.6
5 – 15 Yrs (5)	84	72	36.1	9.0
> 15 Yrs (9)	92	66	39.5	23.8
Non Gilts (50)	22	16	9.4	17.4

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

Month End	US (%)	Euro (%)	Sterling (%)
Oct 09	8.66	9.46	12.81
Nov 09	8.57	9.32	12.03
Dec 09	8.17	8.89	11.70
Jan 10	**8.09**	**8.10**	**10.44**

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

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