JAGGER & ASSOCIATES

Investment Update
November 2010

Investment Headlines & Comment

- More Euro crisis news - **Irish government bond yields** spiked (and the Euro fell 4% and 6.5% against the £ and US Dollar).
- To fund bailouts, the Eurozone is to issue bonds as a group of nations – the **European Financial Stability Facility** (EFSF).
- Meanwhile there are poor **equity market (Euro) returns**, with France, Italy and Spain down 5%, 10% and 14% this month.

Feature Section

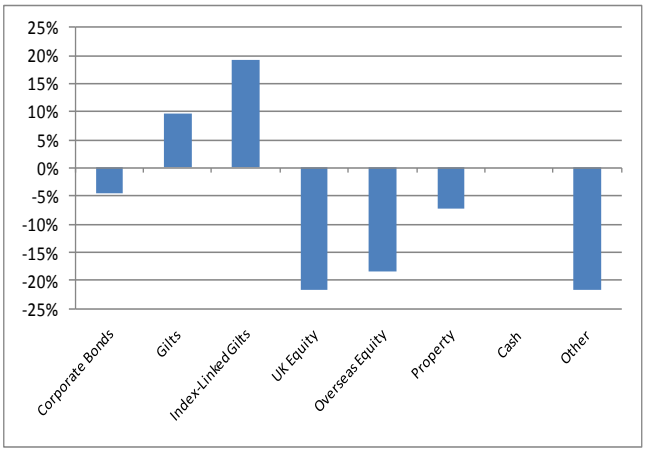
In this month's *Update*, we examine the current Pension Protection Fund (PPF) proposals to introduce investment risk into the calculation of PPF levies. This was always thought a tricky avenue to attempt. So, what have they suggested, and does it work?

The consultation document is on the PPF website. The PPF funding measure would incorporate an allowance for investment risk. For the purpose of the levy calculation, the PPF proposes to adjust the smoothed funding level to reflect further the way adverse movements in asset and liability values can reduce funding levels. The size of the adjustment (or "stress") proposed would depend on how responsive a scheme's funding level would be to a range of investment risks, such as falls in the stock market or interest rate changes. Thus the funding measure in the levy formula would be dependent on an individual scheme's level of investment risk. (***Ed.***: That is, risk as perceived by the PPF.)

The PPF proposes to apply this stress based on data received in the annual return through the Exchange system. However, schemes could voluntarily certify the results of their own calculation in line with the PPF stress scenario based on their own more detailed information of the sensitivity of their portfolio under stressed conditions. (***Ed.***: More fees for consultants?) Schemes that use strategies or products to alter the sensitivity of their assets to particular risks, which are not identifiable through the data captured on the Exchange system, would thus be able to elect to reflect the impacts of these strategies by applying the stress scenario themselves. (***Ed.***: So, for example, if you want to use "cash + equity call option" strategies, and have the paperwork and firepower to do it, this is your chance.)

Figure 1 shows the proposed asset stresses (i.e. factors applied to assets held). These are apparently based on a scenario of (long-term) interest rates falling by 0.6%, corporate bond yields and inflation expectations rising by 1.2% and 0.6% respectively, and schemes having miserable equity returns. (***Ed.***: It's a bit like Animal Farm really. "Equities bad, gilts good, index-linked gilts super-good." Given where real yields already are, partly as a result of LDI-led "buy at any price", this stress scenario appears to involve bringing in sustained negative real yields for virtually all maturities of index-linked gilts. On the bright side, at least any cash holdings are not adjusted, although might there be a case for that depending on where the cash was lodged?)

Figure 1: Asset Value Stresses



Source: PPF

For those with strong stomachs, Annex F of the PPF materials is where to go, to see a detailed example of these stresses in action, in a case where it almost triples the "deficit" from that quoted under the current approach. Admittedly, that is on a hopelessly unrealistic case of a 100% pensioner scheme invested entirely in UK Equities (hence assets penalised by over 20%), but it won't help trustees' perceptions of this matter.

Schemes with strong employer covenants will probably see little effect on their levy – though they may well complain at the additional consultancy costs. Where the employer covenant is weak, and where trustees see equities as the only possible way out of a deficit, this will be yet another unwelcome cost burden.

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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 November 2010

Asset Class	1 month (%)	3 months (%)	12 months (%)	3 years (% p.a.)	5 years (% p.a.)	10 years (% p.a.)	20 years (% p.a.)
UK Equities	-2.3	6.8	11.5	-0.8	4.5	3.1	9.0
Overseas Equities	0.5	9.8	13.6	3.3	5.7	2.3	8.8
US Equities	2.6	**11.8**	16.0	4.4	3.4	0.0	9.9
Europe ex UK Equities	**-6.1**	5.7	0.8	-3.3	5.4	3.3	10.2
Japan Equities	**4.8**	7.2	13.4	0.8	**-0.4**	**-1.4**	**1.7**
Pacific ex Japan Equities	0.7	11.3	**22.7**	7.5	**15.6**	12.7	11.7
Emerging Markets	0.0	9.9	21.9	7.3	15.3	**14.6**	**11.9**
UK Long-dated Gilts	-1.0	-5.5	2.7	6.2	4.1	4.8	9.3
UK Long-dated Corp. Bonds	-2.9	**-5.7**	5.4	5.7	3.2	5.6	-
UK Over 5 Yrs Index-Linked Gilts	-0.1	-1.2	3.1	5.7	5.7	5.8	7.6
High Yield (Global)	-0.1	2.7	20.0	**19.8**	11.3	8.0	-
Overseas Bonds	-2.0	-2.4	5.0	16.9	9.8	6.4	8.1
Property *	0.7	2.1	20.4	**-6.1**	0.9	6.4	7.8
Cash	0.1	0.2	**0.7**	2.7	3.8	4.1	5.8
Commodities £-converted	3.8	11.0	5.9	-5.4	-4.9	-0.3	-
Hedge Funds original $ basis *	2.1	5.5	9.8	0.7	5.9	6.4	12.3
Illustrative £-converted version *	0.6	3.3	13.2	9.9	8.1	5.4	13.5
Euro relative to Sterling	-3.8	1.1	-8.6	5.4	4.2	3.1	-
US $ relative to Sterling	2.7	-1.3	5.4	9.7	2.1	-0.9	1.1
Japanese Yen relative to Sterling	-1.3	-1.1	8.4	20.5	9.7	1.9	3.5
Price Inflation (RPI) *	0.2	1.0	4.5	2.6	3.2	2.8	2.8
Price Inflation (CPI) *	0.3	0.8	3.1	3.0	2.7	2.1	2.3
Price Inflation (RPIX) *	0.2	1.0	4.6	3.7	3.5	2.9	2.9
Earnings Inflation **	0.6	-0.8	2.2	2.0	3.0	3.5	3.9
All Share Capital Growth	-2.5	6.1	8.1	-4.5	0.9	-0.3	5.2
Net Dividend Growth	-2.9	-2.7	-0.3	-3.7	1.0	3.0	-
Earnings Growth	20.4	19.3	63.3	-4.1	4.6	6.2	-

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 Average Weekly Earnings (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.*

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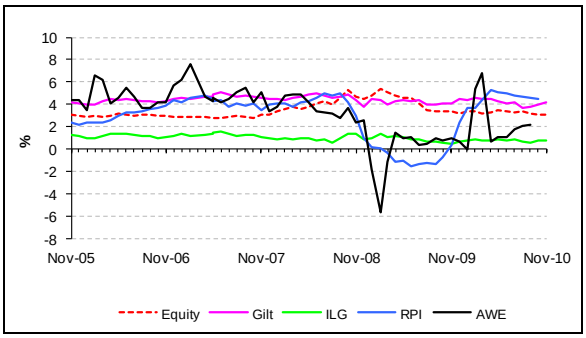
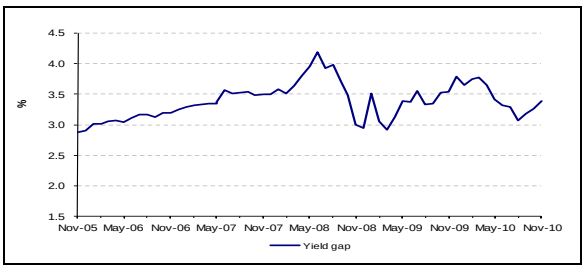
Yields and Yield Gaps

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.

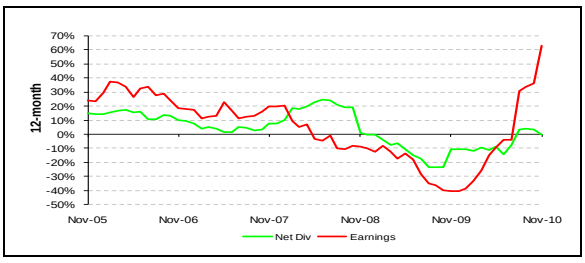


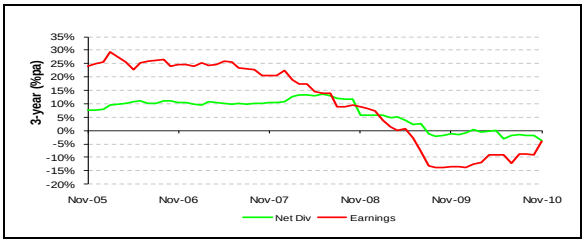
The gap gives expectations just over 3% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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

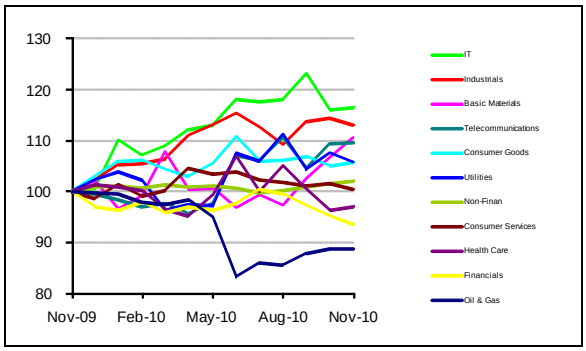




Sources for charts on this page:
Financial Times, Office for National Statistics, J&A

UK Equity Sector Returns

Figure 4a: Sectors relative to All Share



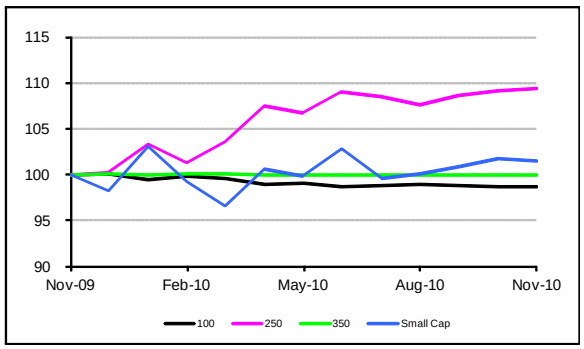
Note: Sector labels for relative lines are in end-value order

A fall this month in the rolling 12-month sector dispersion (down from 32% to 28%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	-2.2	11.0	-1.0
Basic Materials	1.3	21.5	23.2
Industrials	-3.4	10.7	26.1
Consumer Goods	-1.5	6.4	18.0
Health Care	-1.6	-1.4	8.2
Consumer Services	-3.2	5.5	12.1
Telecommunications	-2.2	5.9	22.2
Utilities	-4.0	1.4	17.9
Non-Finan	-1.8	8.8	13.8
Financials	-3.9	0.4	4.4
IT	-1.7	5.5	30.0
All Share	-2.3	6.8	11.5

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Mid Cap and Small Cap rose slightly in relative terms this month.

FRS17 volatility indicator

Now discontinued, but available on request.

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Bond market information

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

Figure 5: £ Non-Gilt Credit Margins

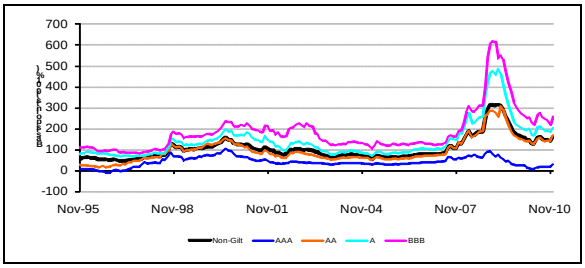

Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
Jun 10	5.25	4.10	1.15
Jul 10	5.29	4.18	1.11
Aug 10	4.75	3.67	1.08
Sep 10	4.89	3.77	1.12
Oct 10	5.17	4.01	1.16
Nov 10	**5.42**	**4.13**	**1.29**

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

Category	Mkt Val (£bn @ Nov 10 & 08, 06)			Weight (%)
Gilts (34)	820	466	327	63.3
Non Gilts (1,025)	476	403	415	36.7
AAA (182)	144	153	154	11.1
AA (175)	73	71	67	5.6
A (393)	165	118	126	12.7
BBB (275)	95	58	66	7.3

Category	Mkt Val (£bn @ Nov 10, 08)		W't (%)	Dur'n (yrs)
Gilts (34)	820	466	63.3	8.8
< 5 Yrs (9)	260	133	20.0	2.8
5–15 Yrs (11)	282	149	21.8	7.3
> 15 Yrs (14)	278	184	21.5	16.0
Non Gilts (1,025)	476	403	36.7	7.2
< 5 Yrs (267)	139	141	10.7	2.3
5–15 Yrs (469)	202	150	15.6	6.8
> 15 Yrs (289)	136	112	10.5	12.8

£ Gilt Market "main" Issuance

- £4.40bn 2% 2016 (2.00x, 1.96%, new)
- £3.25bn 3¾% 2020 (1.77x, 3.45%, prev Oct 10)
- £2.06bn 4½% 2034 (1.53x, 4.19%, Aug 10)
- £0.60bn ILG 1¼% 2027 (2.31x, r.y 0.78%, Sept 10)
- £0.77bn ILG 1¼% 2055 (2.11x, r.y 0.62%, Dec 08)

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

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (253)	3,924	57.4
Non Sovereigns	2,914	42.6
AAA (663)	1,286	18.8
AA (425)	599	8.8
A (634)	677	9.9
BBB (430)	352	5.2

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (712)	1,898	27.8
3 – 5 Yrs (700)	1,641	24.0
5 – 7 Yrs (424)	967	14.1
7 – 10 Yrs (341)	1,112	16.3
10+ Yrs (228)	1,221	17.9

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Nov 10 & 08)		W't (%)	Dur'n (yrs)
Gilts (16)	239	155	90.8	15.7
< 5 Yrs (1)	21	30	8.1	2.6
5 – 15 Yrs (5)	96	53	36.5	8.4
> 15 Yrs (10)	121	72	46.2	23.7
Non Gilts (49)	24	16	9.2	17.6

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

Month End	US (%)	Euro (%)	Sterling (%)
Aug 10	7.74	7.73	9.29
Sep 10	7.31	7.16	8.56
Oct 10	7.04	7.10	8.67
Nov 10	**7.40**	**8.21**	**9.70**

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