



## Investment Update December 2010

### Investment Headlines & Comment

- **Euro woes** - Ireland downgraded again. 10 year yields now 9% for Ireland but over 12% for Greece (and only 3% for Germany).
- **UK Equity market earnings** have rebounded dramatically from their lows, up 64% over the last 12 months.
- The remains of **Gartmore** may be going to **Henderson**. Meanwhile, **F&C** have been losing **Thames River** staff they acquired.

### Feature Section

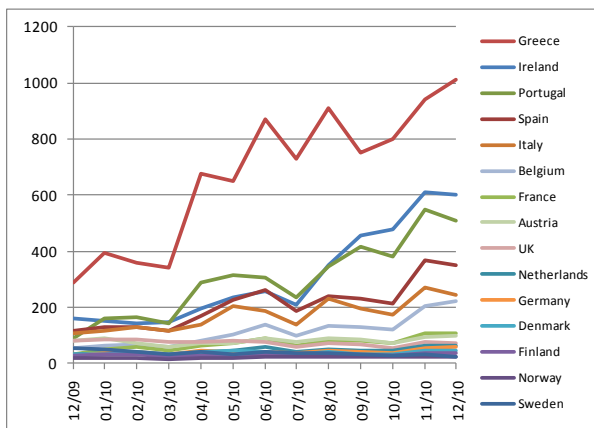
In this month's *Update*, we revisit the world of Credit Default Swaps (CDSs), first explored in our April 2005 *Update*. Back then, the "default" of concern was from corporate bonds but CDSs can now be used to assess the financial state of some European governments.

As a quick reminder, under a CDS, small payments are made by the investor to an 'insurer' in return for a (large) payment if a specified bond defaults in a set time period. If the investor owns the bond, or is affected by its value, then the risk level of their portfolio has gone down (because of removing the effect of the default), but so too has the expected return (because of the cost of the CDS). See our April 2005 *Update* for more on the counterparty aspect of the 'insurer'. Portfolios of CDSs can be traded (e.g. through iTraxx for companies – see [www.creditfixings.com](http://www.creditfixings.com)), and these products can be regarded as a cost-effective temporary hedge to get into or out of the relevant bond markets, with positions unwound as the underlying physical asset portfolio is revised – this is akin to using futures in equity markets, and reducing them as the desired trades in specific equities are achieved.

The investor does not usually have to own the relevant bond, but this situation is increasingly contentious in the wake of the 'credit crunch', as it has been felt that speculators have been creating additional instability. This ownership point is relevant for how CDSs settle their payouts, which can either be *physical settlement* (the protection seller pays the investor the par value, and in return takes delivery of a debt obligation of the reference entity, which would be possible if the investor owned the bond), or *cash settlement* (the protection seller pays the investor the difference between par value and the then market price of the bond, which would be a relevant approach if the investor did not own the bond). Most transactions are now done on a cash settlement basis.

In mid 2009, indices were developed by Markit in their iTraxx SovX family of indices to cover government bonds, and it is the outputs on the European series that are of most interest at the moment. The rates quoted are in basis points, and reflect the annual cost of insuring against default over the next five years, so for example a rate of 400 basis points on a €10m portfolio would equate to an annual premium of €400,000 per year, and hence a cost of €2m if the default does not happen, but a potential recovery of up to €10m if it does. If there is a recovery rate on the bond, that reduces the counterparty's payout (as noted in the cash settlement point earlier), but beyond that there is a further risk of whether the counterparty will deliver the relevant remaining payout at all (which is relevant, given there is no collateral involved). So, CDS recovery rates are a curious mix of these two factors.

**Figure 1: European Government CDS rates**



Sources: Bloomberg, Markit

Figure 1 shows the way that 5-year CDS rates have moved over the last 12 months. The vertical axis is in basis points (100 basis points = 1%). The country labels are in descending order for the end values. 5-year CDS rates are quite distinct from 5-year yields – for example, the Greek 5-year yield is currently at over 13% (the CDS is nearer 10%), and the Irish 5-year yield is a little below 8% (the CDS is at about 6%).

Taking the current 10% Greek and 0.2% Swedish CDS rates as examples, and using a simplified probability model, it follows that a 25% recovery rate is currently associated with a 40% chance of default for Greece and a 1% chance for Sweden. As the chance of default is increased (and hence the chance of payout *increases*), the required recovery rate for breaking even decreases.



**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 December 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	7.1	7.4	14.5	1.4	5.1	3.7	9.4
Overseas Equities	6.9	9.6	17.2	4.8	6.4	3.4	9.0
US Equities	6.1	11.5	18.8	5.6	4.5	1.1	10.4
Europe ex UK Equities	<b>8.6</b>	5.1	6.6	-1.3	6.1	3.9	10.3
Japan Equities	7.2	<b>12.8</b>	19.0	3.5	<b>-0.8</b>	<b>0.6</b>	<b>1.8</b>
Pacific ex Japan Equities	6.3	8.3	<b>23.9</b>	8.9	<b>15.7</b>	13.6	12.0
Emerging Markets	6.5	8.0	22.9	8.1	15.2	<b>15.6</b>	<b>12.1</b>
UK Long-dated Gilts	1.0	-3.5	8.8	5.6	3.9	4.8	9.1
UK Long-dated Corp. Bonds	1.1	<b>-3.9</b>	9.5	5.4	2.9	5.6	-
UK Over 5 Yrs Index-Linked Gilts	2.8	1.1	9.0	5.9	5.8	6.1	7.8
High Yield (Global)	1.7	2.8	17.5	<b>19.2</b>	11.3	8.5	-
Overseas Bonds	1.0	-1.1	9.9	16.2	9.6	6.7	8.1
Property *	0.7	2.1	17.6	<b>-4.7</b>	0.6	6.4	7.8
Cash	<b>0.1</b>	0.2	<b>0.7</b>	2.5	3.7	4.1	5.7
Commodities £-converted	8.8	14.1	12.4	<b>-5.7</b>	<b>-3.9</b>	1.3	4.7
Hedge Funds original \$ basis *	0.2	5.8	8.4	1.5	5.6	6.8	12.3
Illustrative £-converted version *	2.9	4.5	14.2	11.4	7.9	5.8	13.6
Euro relative to Sterling	2.5	-1.1	-3.6	5.3	4.5	3.1	-
US \$ relative to Sterling	-0.6	0.6	3.1	8.2	1.9	-0.5	1.1
Japanese Yen relative to Sterling	2.8	3.6	18.3	20.5	9.8	3.0	3.7
Price Inflation (RPI) *	0.4	1.0	4.7	2.6	3.2	2.8	2.8
Price Inflation (CPI) *	0.3	0.6	3.2	3.1	2.8	2.1	2.3
Price Inflation (RPIX) *	0.4	1.0	4.7	3.7	3.6	2.9	3.0
Earnings Inflation **	-0.5	-0.3	2.1	2.1	3.0	3.5	3.9
All Share Capital Growth	7.0	6.8	10.9	-2.3	1.5	0.3	5.6
Net Dividend Growth	0.1	-2.6	0.2	-3.7	1.1	2.9	-
Earnings Growth	0.0	18.9	63.7	-4.2	4.5	6.0	-

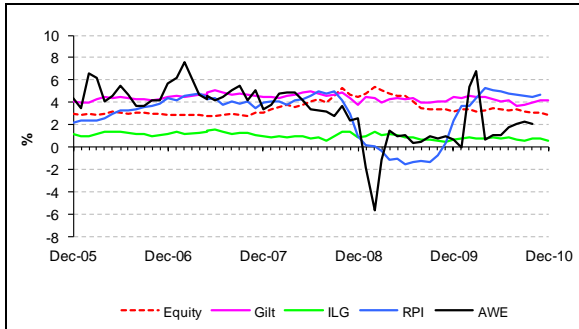
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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 – 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.



## 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.

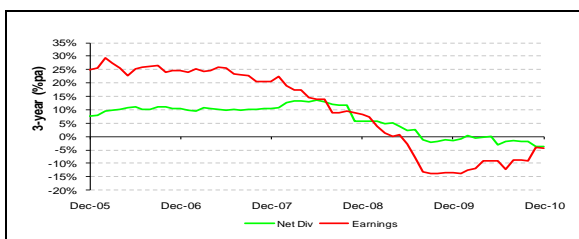
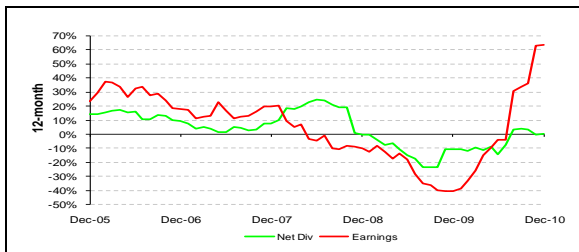


The gap gives expectations of about 3.5% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

## 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]

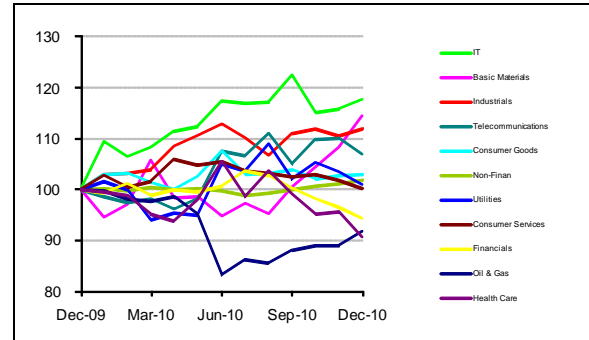
Figure 3: Dividend & Earnings Growth



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



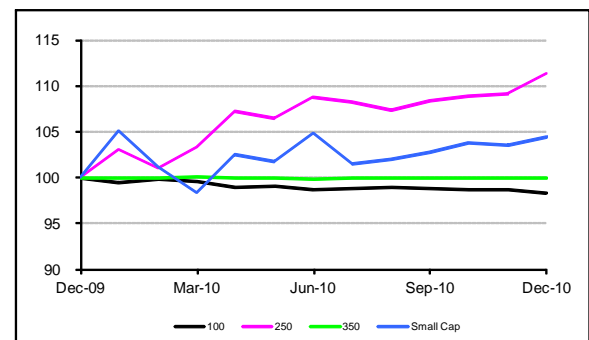
Note: Sector labels for relative lines are in end-value order

A slight fall this month in the rolling 12-month sector dispersion (down from 28% to 27%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	10.4	11.8	5.0
Basic Materials	13.3	22.3	31.0
Industrials	8.5	8.2	28.2
Consumer Goods	7.2	6.3	17.8
Health Care	1.4	-1.9	3.7
Consumer Services	5.3	4.8	14.6
Telecommunications	4.0	9.2	22.2
Utilities	4.6	6.2	15.6
Non-Finan	7.9	9.4	16.6
Financials	4.6	1.0	8.0
IT	8.8	3.2	34.7
All Share	7.1	7.4	14.5

## UK Equity Size Returns

Figure 4b: Size groups relative to All Share



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

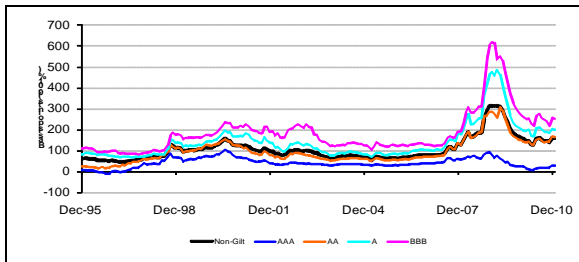
## FRS17 volatility indicator

Now discontinued, but available on request.



**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 (%)
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
Dec 10	<b>5.35</b>	<b>4.14</b>	<b>1.21</b>

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

Category	Mkt Val (£bn @ Dec 10 & 08, 06)			Weight (%)
Gilts (35)	827	502	319	63.9
Non Gilts (1,023)	467	419	405	36.1
AAA (183)	136	161	149	10.5
AA (174)	72	73	65	5.6
A (387)	162	121	123	12.6
BBB (279)	96	62	64	7.4

Category	Mkt Val (£bn @ Dec 10, 08)		W't (%)	Dur'n (yrs)
Gilts (35)	827	502	63.9	8.8
< 5 Yrs (9)	257	143	19.9	2.7
5-15 Yrs (12)	286	162	22.1	7.2
> 15 Yrs (14)	283	198	21.9	16.0
Non Gilts (1,023)	467	419	36.1	7.4
< 5 Yrs (261)	130	150	10.0	2.4
5-15 Yrs (470)	199	152	15.4	6.8
> 15 Yrs (292)	138	118	10.6	12.9

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

**£ Gilt Market “main” Issuance**

- o £3.85bn 2% 2016 (1.93x, 2.56%, prev Nov 10)
- o £2.20bn 4¼% 2049 (1.82x, 4.38%, Jan10)
- o £0.88bn ILG 5/8% 2042 (1.93x, r.y 0.76%, Oct 10)

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

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (256)	3,954	57.7
Non Sovereigns	2,897	42.3
AAA (656)	1,261	18.4
AA (429)	597	8.7
A (650)	687	10.0
BBB (430)	352	5.1

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (709)	1,892	27.6
3 – 5 Yrs (697)	1,643	24.0
5 – 7 Yrs (437)	973	14.2
7 – 10 Yrs (346)	1,130	16.5
10+ Yrs (232)	1,212	17.7

**Table 2f: Breakdown of £ Index-Linked Market**

Category (Number of issues)	Mkt Val (£bn @ Dec 10 & 08)		W't (%)	Dur'n (yrs)
Gilts (16)	246	173	90.8	15.8
< 5 Yrs (1)	21	32	7.9	2.5
5 – 15 Yrs (5)	97	58	35.8	8.3
> 15 Yrs (10)	128	82	47.1	23.8
Non Gilts (49)	25	18	9.2	17.7

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

Month End	US (%)	Euro (%)	Sterling (%)
Jul 10	7.70	7.83	9.59
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
Dec 10	<b>7.24</b>	<b>7.53</b>	<b>8.60</b>

