JAGGER & ASSOCIATES

Investment Update
March 2010

Investment Headlines & Comment

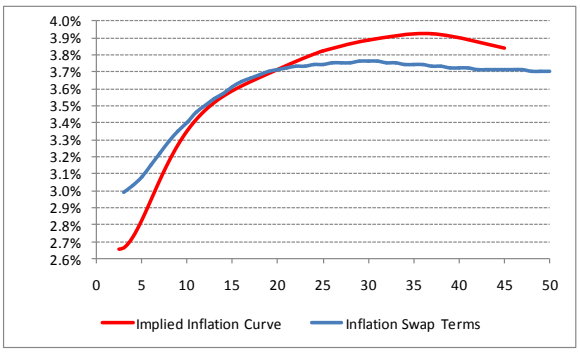
- **Government bond news** – Portugal gets downgraded, Finland goes for Sterling issuance.
- **Insider trading** – a hedge fund in FSA raids and a similar question over a senior Gartmore manager.
- The **National Average Earnings index** is replaced by Average Weekly Earnings (AWE ?).

Feature Section

The features in this issue and the next Update consider two varieties of protection, and the price attached to them. This month, we consider inflation protection. You start with Index-Linked Gilts, but if they appear too expensive (see for example the real yields in Figure 2 on page 3), what alternatives are there? Is there strong inflation-linking, on income and/or on capital? One option to achieve an element of inflation protection is to use Absolute Return products – these were discussed in our October 2007 issue of Update, but the short-term correlation between their total returns and inflation could be described as loose. Another route is to invest in a property fund which has long-lease tenants, with inflation-linked rental uplifts. The income stream may thus have inflation-protection, but you'd still have 'fingers crossed' for the capital values rising with inflation.

Another option is inflation-linked corporate bonds, however the market for these is very small (see Table 2f on page 4) and no pooled funds exist. However, exposure can be achieved in a pooled fund, such as a corporate bond fund, by the manager adding on RPI swaps for the underlying payment profile to create "inflation + corporate real yield". *Illustrative* terms on which these RPI swaps are bought in current market conditions are shown by the blue line in Figure 1 below (*sources: Bank of England, L&G*).

Figure 1: Annualised Inflation Curves in years



The red line in Figure 1 shows the gilt market's current implied inflation rate, although there is no adjustment for potential distortions due to the small size of the index-linked market versus the conventional gilt market. The blue line in Figure 1 shows that for inflation over the next 10 years, the investor / fund would pay inflation at a fixed rate of 3.4% p.a. to the swap's counterparty, and they undertake to pay the actual inflation to the fund – so if inflation is high over the period, the fund is 'insured' against this. Equally, if inflation is below 3.4% p.a. over the period, it is like having paid an insurance premium without getting any benefit (i.e. not making a claim).

Both the red and blue lines can involve distortion, either in particular areas or indeed across the whole curve. For example, we suspect the year-by-year rates underlying the "cumulative" rates in the red line in Figure 1 understate the actual year-to-year volatility in inflation that would be experienced. Also, the reasons for the two lines diverging can be peculiar. At the short end, implied inflation (as shown by the red line) is lower than the market rate (as shown by the blue line) at lower maturities. The most likely reason is that the bulk of the Bank of England's quantitative easing purchases were nominal gilts at the short end (and no index-linked gilts at all), putting downward pressure on nominal gilt yields. As the implied rate is the difference between the nominal and real gilt yields, this results in a relatively lower implied inflation rate at the short end.

At the longer end, there is anecdotal evidence (e.g. from DMO auction results) of continued demand for the limited supply of ultra-long index-linked gilts putting downward pressure on gilt real yields, but that this is weaker than the demand for ultra-long conventional gilts. Thus the red line curves downwards after (about) 35 years. There is also anecdotal evidence that some holders of index-linked gilts are entering into swap contracts to get LIBOR over a long period instead of index-linking (whereas if they sold the gilts, they would not have the lock-in on cash rates for a long period). This has increased the inflation swap supply, thereby reducing the inflation swap rate (the blue line, which is below the red line from roughly 20 years' time onwards).

Investors need to be aware of the potential risks involved with products using swaps, and how these are mitigated. The risk exists of a swap counterparty defaulting (hence the lodging of collateral); the swaps market can at times be illiquid or volatile, and in some cases, depending on the nature of the contract, no independent valuation may be available which leads to uncertainty as to the fair value of the swap. However, if used carefully, RPI swaps could be a useful tool.

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 March 2010

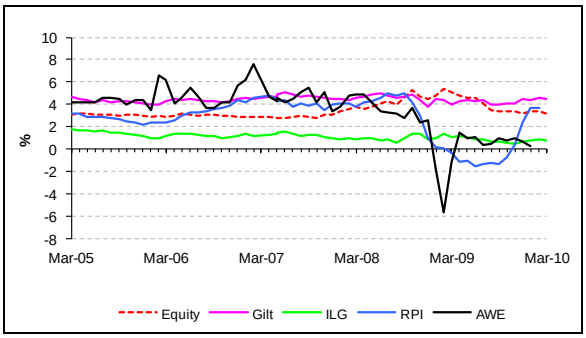
Asset Class	1 month (%)	3 months (%)	12 months (%)	3 years (% p.a.)	5 years (% p.a.)	10 years (% p.a.)
UK Equities	6.8	6.4	52.3	-0.2	7.2	2.6
Overseas Equities	7.0	10.3	48.1	5.7	9.9	2.1
US Equities	6.4	12.4	41.8	4.8	7.0	0.0
Europe ex UK Equities	7.6	4.4	50.2	1.8	10.2	3.8
Japan Equities	5.5	**15.4**	29.6	-0.7	5.5	**-2.4**
Pacific ex Japan Equities	8.0	9.1	69.3	14.6	19.1	**10.6**
Emerging Markets	**8.4**	9.1	**71.5**	14.9	**21.2**	**10.6**
UK Long-dated Gilts	1.5	**0.2**	**-0.2**	4.4	4.5	4.6
UK Long-dated Corp. Bonds	2.7	3.4	21.4	3.5	4.1	5.9
UK Over 5 Yrs Index-Linked Gilts	3.0	2.0	10.4	6.8	6.4	5.7
High Yield (Global)	3.7	11.3	52.7	16.6	12.9	8.1
Overseas Bonds	**-1.6**	5.6	0.0	**17.7**	9.9	7.2
Property *	1.9	7.3	11.1	**-8.6**	**1.3**	6.2
Cash	0.1	**0.2**	0.9	3.9	4.3	4.5
Commodities £-converted	2.3	5.5	18.9	-0.6	-2.8	4.2
Hedge Funds original $ basis *	0.6	1.1	21.4	1.6	5.3	5.7
Illustrative £-converted version *	5.9	9.0	13.6	10.5	10.3	6.1
Euro relative to Sterling	-0.5	0.4	-3.7	9.5	5.3	4.0
US $ relative to Sterling	0.3	6.5	-5.5	8.9	4.5	0.5
Japanese Yen relative to Sterling	-4.5	6.1	-0.1	17.8	7.4	1.4
Price Inflation (RPI) *	0.6	1.2	3.7	2.6	2.9	2.7
Price Inflation (CPI) *	0.4	0.8	3.0	2.9	2.7	2.0
Price Inflation (RPIX) *	0.6	1.2	4.2	3.5	3.3	2.8
Earnings Inflation **	-0.6	2.6	0.2	0.7	2.3	3.5
All Share Capital Growth	6.3	5.4	46.7	-3.9	3.4	-0.7
Net Dividend Growth	0.3	4.1	-9.5	-0.5	3.9	3.4
Earnings Growth	4.0	14.5	-26.1	-12.0	1.0	3.8

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

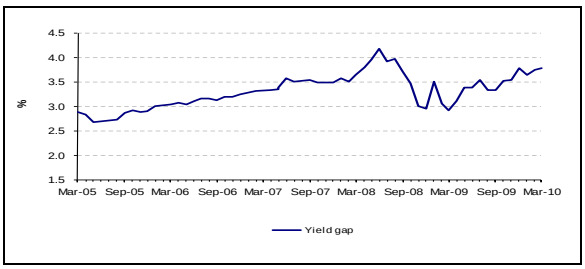
- *UK Equities (incl. dividends and earnings) – FT-A All Share.*
- *Overseas Equities (incl. regions) – blend of FT All-World / World subindices*
- *Emerging Markets from MSCI US $ based total return index (overall Index to 31 Oct 2001, Free Index from 1 Nov 2001 to take account of foreign investment 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.

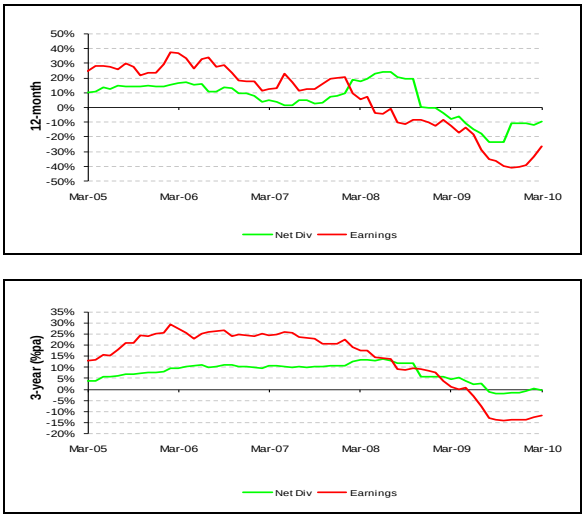


The gap gives expectations over 3.5% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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*]

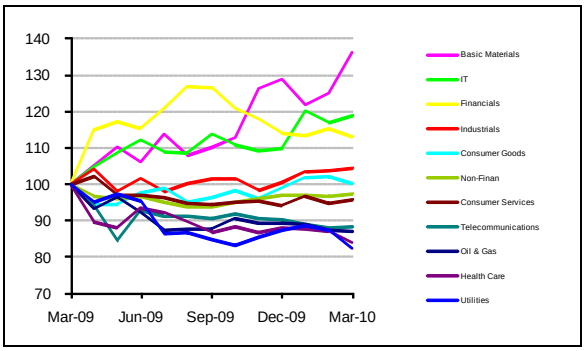
Figure 3: Dividend & Earnings Growth



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



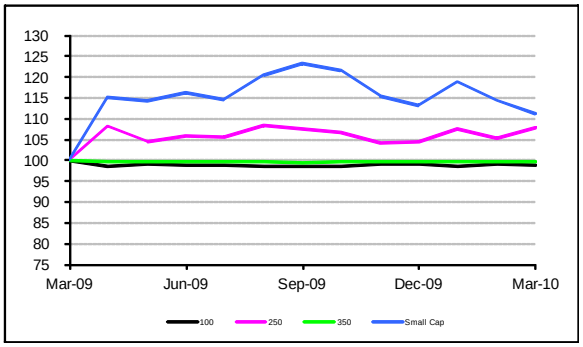
Note: Relative lines' labels for sectors in end-value order

A major decrease this month in the rolling 12-month sector dispersion (down from 74% to 54%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	6.4	4.0	32.8
Basic Materials	16.4	12.5	107.1
Industrials	7.6	10.6	58.9
Consumer Goods	4.9	7.8	52.7
Health Care	2.8	1.2	27.6
Consumer Services	7.9	8.0	45.6
Telecommunications	7.3	4.3	34.6
Utilities	0.5	0.1	25.3
Non-Finan	7.5	6.8	48.0
Financials	4.5	5.2	71.9
IT	8.6	15.2	81.0
All Share	6.8	6.4	52.3

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Small Cap fell back markedly in relative terms this month, but Mid Cap rose slightly.

FRS17 volatility indicator

Now discontinued, but available on request.

Bond market information

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

Figure 5: £ Non-Gilt Credit Margins

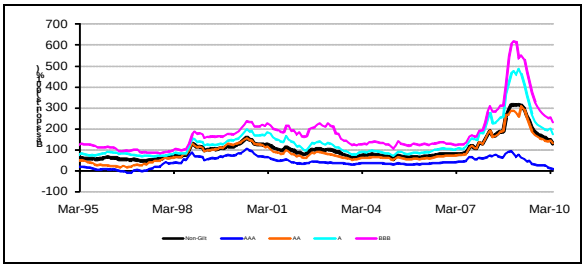


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
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
Feb 10	5.63	4.58	1.05
Mar 10	**5.42**	**4.49**	**0.93**

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

Category	Mkt Val (£bn @ Mar 10 & 08, 06)			Weight (%)
Gilts (34)	718	339	245	60.5
Non Gilts (1,029)	469	410	296	39.5
AAA (186)	146	157	107	12.3
AA (188)	73	60	40	6.2
A (383)	160	126	92	13.5
BBB (272)	90	64	51	7.6

Category	Mkt Val (£bn @ Mar 10, 08)		W't (%)	Dur'n (yrs)
Gilts (34)	718	339	60.5	8.7
< 5 Yrs (10)	223	81	18.8	2.7
5–15 Yrs (10)	234	117	19.7	7.0
> 15 Yrs (14)	261	141	22.0	15.4
Non Gilts (1,029)	469	410	39.5	7.2
< 5 Yrs (273)	139	134	11.7	2.4
5–15 Yrs (474)	200	158	16.8	6.9
> 15 Yrs (282)	130	118	11.0	12.8

£ Gilt Market "main" Issuance

- £4.32bn 2¾% 2015 (2.33x, 2.80%, prev Jan 10)
- £3.57bn 4¾% 2020 (2.13x, 3.99%, Oct 09)
- £3.30bn 4% 2022 (2.01x, 4.33%, Nov 09)
- £1.00bn 6% 2028 (1.79x, 4.56%, Sep 09)
- £2.17bn 4¼% 2039 (1.92x, 4.59%, Dec 09)
- £0.90bn ILG 1¼% 2032 (1.83x, r.y 0.95%, Nov 09)

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

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (274)	4,002	57.9
Non Sovereigns	2,909	42.1
AAA (661)	1,315	19.0
AA (389)	571	8.3
A (631)	680	9.8
BBB (402)	343	5.0

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (712)	1,949	28.2
3 – 5 Yrs (707)	1,680	24.3
5 – 7 Yrs (397)	948	13.7
7 – 10 Yrs (324)	1,124	16.3
10+ Yrs (217)	1,211	17.5

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Mar 10 & 08)		W't (%)	Dur'n (yrs)
Gilts (17)	222	166	90.5	14.4
< 5 Yrs (2)	35	23	14.5	2.5
5 – 15 Yrs (5)	88	74	35.9	8.9
> 15 Yrs (10)	98	69	40.1	23.6
Non Gilts (51)	23	16	9.5	17.8

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

Month End	US (%)	Euro (%)	Sterling (%)
Jan 10	8.09	8.10	10.44
Feb 10	8.23	8.74	10.74
Mar 10	**7.73**	**7.58**	**9.48**

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