JAGGER & ASSOCIATES

Investment Update
June 2010

Investment Headlines & Comment

- **The Euro** fell this month and **Greek bond yields** rose sharply. The **LIBOR spread** over base rate increased as well.
- Medium- and long-dated gilts did well as a result. Also, there was syndicated issuance of a massive £8bn of a new **2040 gilt**.
- **Threadneedle** have lost two Absolute Return bond managers to **RWC (**who hired the Schroders equity exits we noted last month).

Feature Section

This month, we consider what pension fund trustees can and cannot do in relation to investments, and by extension what their consultants can and cannot advise. This includes consideration of those grey areas where "can do" becomes "can do but not advisable" (which equate for some to "only do it if you've got a reputable lawyer to support you unambiguously").

Section 191 of the Financial Services Act 1986 (FSA 1986) is the start point. It required that the trustees of a pension fund had to be authorised under the FSA 1986 unless all decisions or all day-to-day decisions in relation to pension scheme investments were made on their behalf by an authorised person. This broad concept continues under the various Pension Acts and the Financial Services and Markets Act 2000 ("FSMA 2000"), but with some amendments that we will come to later in this note.

The law is less onerous on charity trustees and others, because they are only regulated if their work is "carried on by way of business", which is not the case for the vast majority of trustees. So, they can make more detailed decisions if they want to, although delegation to professionals may still be preferable.

Traditionally, pension trustees complied with their area's legislation by delegating the aforementioned day-to-day investment decisions to professional investment managers who were FSA authorised. The pension trustees were still involved in determining their scheme's investment strategy, and then passed it to the investment managers for implementation. For most trustees, this structure involved periodic (triennial) reviews of asset allocation, with more frequent monitoring of its implementation. Incidentally, this contrasts with the loss of control for trustees if "implemented consulting" is adopted (where there is the further concern that the implementer does not accept liability for or guarantee their impact).

It used to be rare for trustees to make more frequent asset allocation changes, but some trustees now want to be far more "hands on" – although whether some quite appreciate the extent to which they can get things wrong (as well as right) is another matter. In fairness, if market conditions change materially (be it over a period of weeks or over years) after an investment strategy is implemented, then pension trustees ought to be able to amend their strategy legitimately, to take advantage of potential new opportunities or to protect their assets from perceived threats.

So, for example, if credit margins were unusually wide, some trustees might see this as more than sufficient for the risk involved, and hence they would increase their corporate bond exposure. Alternatively, after a strong equity market run, they might reduce their equity exposure (or conversely, they could increase it after a marked fall in markets).

However, doubt about these actions can set in, if these changes are being made too frequently – can such actions fall foul of the vague definition originated in FSA 1986 of delegated day-to-day decisions?

The definition clearly included decisions that were taken on a day-to-day basis but it could in addition include a variety of one-off decisions that might also be taken on a day-to-day basis (such as the examples in the previous paragraph). This situation was "clarified" by some FSMA 2000 regulations which legitimise pension trustees making these decisions *provided* they are in accordance with advice given by an authorised person who has permission to carry out certain activities specified in the FSMA 2000 (Regulated Activities) Order 2001 (or certain specified persons as defined in this order).

Arguably, this simply passes the problem to the adviser, particularly in situations where the adviser does not have complete FSA authorisation, e.g. they may have permission for some areas but not have authorisation to *manage* investments, which is the case for most (DPB) actuarial firms.

Some advisers may go (and indeed have gone) to get legal opinions that say they can advise a client on the purchase of a specific bond, or on high-frequency changes to asset allocation. Others may say that if the area is grey enough that it needs a legal opinion to even consider doing it, then it is best left well alone.

It then becomes an issue for the adviser of whether short-term fee-earning is worth the later risk of being the fall-guy for their client in any subsequent litigation when it has all gone wrong.

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 June 2010

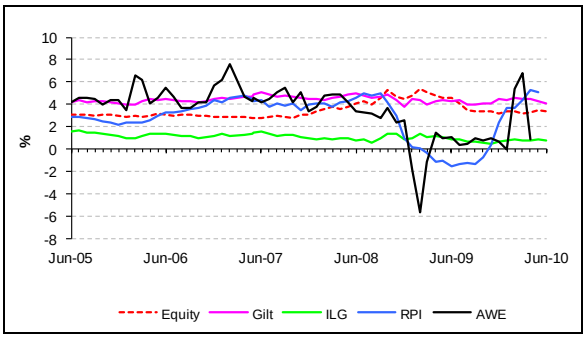
Asset Class	1 month (%)	3 months (%)	12 months (%)	3 years (% p.a.)	5 years (% p.a.)	10 years (% p.a.)
UK Equities	-4.6	-11.8	21.1	-5.7	3.5	1.6
Overseas Equities	-5.7	-10.5	24.1	0.1	6.0	0.7
US Equities	**-8.0**	-10.4	26.0	-0.1	3.2	-1.3
Europe ex UK Equities	-3.2	**-14.2**	17.0	-5.4	5.9	1.7
Japan Equities	-4.8	-8.7	10.5	-2.8	3.2	**-3.1**
Pacific ex Japan Equities	-1.8	-6.9	34.6	7.7	15.3	9.5
Emerging Markets	-3.6	-7.0	35.9	7.8	**17.2**	**10.4**
UK Long-dated Gilts	**2.3**	**6.4**	8.0	8.4	4.5	5.1
UK Long-dated Corp. Bonds	1.8	3.1	17.6	6.1	3.4	6.5
UK Over 5 Yrs Index-Linked Gilts	1.8	1.6	8.4	8.1	5.8	5.6
High Yield (Global)	-1.8	-0.7	**38.9**	17.0	11.2	7.5
Overseas Bonds	-1.7	2.8	15.4	**20.4**	9.6	6.9
Property *	1.1	4.8	22.4	**-7.8**	**1.5**	6.4
Cash	0.1	0.2	**0.7**	3.5	4.1	4.4
Commodities £-converted	-2.5	-9.2	4.1	-3.5	-4.8	1.0
Hedge Funds original $ basis *	-2.8	0.8	10.5	0.3	5.8	6.2
Illustrative £-converted version *	2.4	5.6	22.7	11.2	10.6	6.5
Euro relative to Sterling	-3.0	-8.2	-3.8	6.8	3.9	2.6
US $ relative to Sterling	-2.9	1.4	10.1	10.3	3.7	0.1
Japanese Yen relative to Sterling	-0.1	7.0	20.0	23.2	8.4	1.9
Price Inflation (RPI) *	0.4	2.0	5.1	2.7	3.1	2.7
Price Inflation (CPI) *	0.2	1.3	3.3	3.0	2.7	2.1
Price Inflation (RPIX) *	0.4	2.0	5.1	3.7	3.4	2.9
Earnings Inflation **	-11.1	0.1	0.8	2.4	3.1	3.5
All Share Capital Growth	-4.9	-12.6	17.1	-9.3	-0.1	-1.7
Net Dividend Growth	-9.5	-7.6	-14.2	-3.2	1.4	2.6
Earnings Growth	0.6	17.0	-4.0	-9.1	3.1	5.4

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

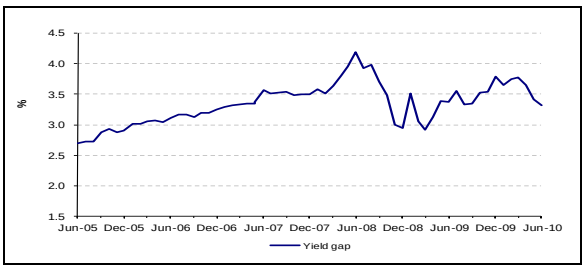
- *UK Equities (incl. dividends and earnings) – FT-A All Share.*
- *Overseas Equities (incl. regions) – blend of FT All-World / World subindices*
- *Emerging Markets from MSCI US $ based total return index (overall Index to 31 Oct 2001, Free Index from 1 Nov 2001 to take account of foreign investment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

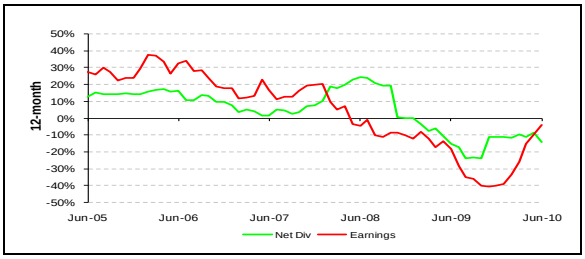


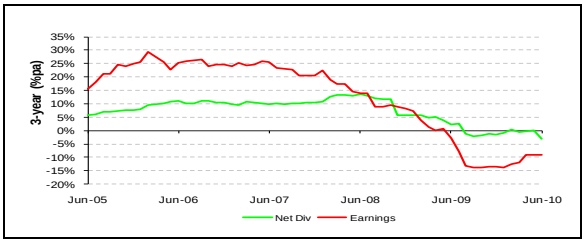
The gap gives expectations slightly below 3.5% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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

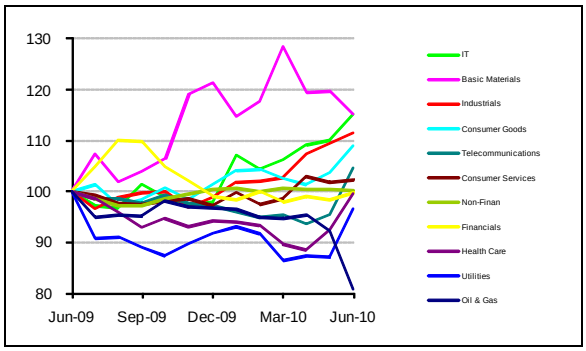




Sources for charts on this page:
Financial Times, Office for National Statistics, J&A

UK Equity Sector Returns

Figure 4a: Sectors relative to All Share



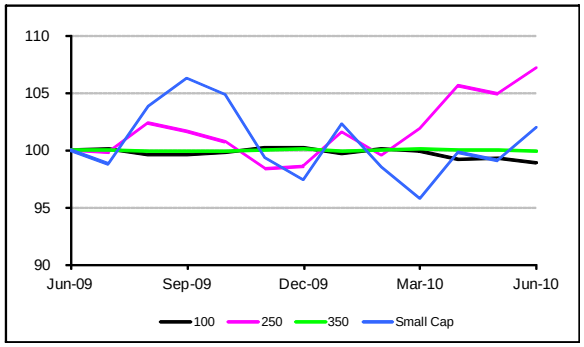
Note: Sector labels for relative lines are in end-value order

A rise this month in the rolling 12-month sector dispersion (up slightly from 30% to 34%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	-16.4	-24.8	-2.3
Basic Materials	-8.3	-21.0	39.3
Industrials	-2.7	-4.4	35.0
Consumer Goods	0.1	-6.4	31.8
Health Care	2.6	-2.3	20.4
Consumer Services	-4.2	-8.4	24.0
Telecommunications	4.4	-3.3	26.6
Utilities	5.6	-1.5	16.8
Non-Finan	-5.0	-12.3	21.3
Financials	-3.4	-10.1	20.8
IT	-0.3	-4.3	39.3
All Share	-4.6	-11.8	21.1

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



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

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

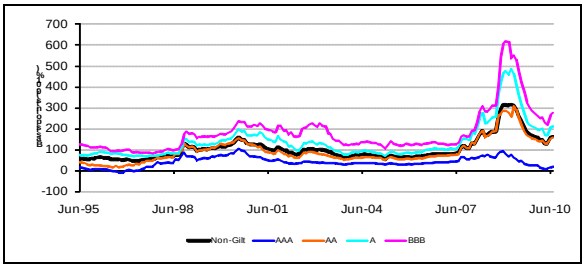


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
Jan 10	5.46	4.38	1.08
Feb 10	5.63	4.58	1.05
Mar 10	5.42	4.49	0.93
Apr 10	5.38	4.44	0.94
May 10	5.39	4.25	1.14
Jun 10	**5.25**	**4.10**	**1.15**

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

Category	Mkt Val (£bn @ Jun 10 & 08, 06)			Weight (%)
Gilts (33)	760	343	306	61.8
Non Gilts (1,028)	469	419	386	38.2
AAA (177)	141	148	147	11.5
AA (184)	75	72	64	6.1
A (396)	164	131	113	13.3
BBB (271)	89	67	58	7.3

Category	Mkt Val (£bn @ Jun 10, 08)		W't (%)	Dur'n (yrs)
Gilts (33)	760	343	61.8	9.0
< 5 Yrs (9)	211	88	17.2	2.7
5–15 Yrs (11)	292	116	23.7	7.2
> 15 Yrs (13)	257	139	20.9	16.2
Non Gilts (1,028)	469	419	38.2	7.3
< 5 Yrs (264)	134	138	10.9	2.4
5–15 Yrs (478)	204	163	16.6	6.9
> 15 Yrs (286)	132	118	10.7	12.9

£ Gilt Market "main" Issuance

- £4.40bn 5% 2014 (2.28x, 2.03%, prev Jun 09)
- £4.67bn 2¾% 2015 (2.34x, 2.27%, Mar 10)
- £3.75bn 3¾% 2020 (1.86x, 3.63%, new)
- £2.18bn 4½% 2034 (1.87x, 4.33%, Feb 10)
- £8bn (*yes, £8bn*) 4¼% 2040 (1.73x, 4.24%, new)
- £1.10bn ILG 1¼% 2027 (1.63x, r.y. 0.94%, Dec 09)

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

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (278)	4,104	58.9
Non Sovereigns	2,870	41.2
AAA (653)	1,287	18.5
AA (383)	563	8.1
A (626)	676	9.7
BBB (413)	343	4.9

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (698)	1,933	27.7
3 – 5 Yrs (688)	1,650	23.7
5 – 7 Yrs (411)	975	14.0
7 – 10 Yrs (343)	1,179	16.9
10+ Yrs (213)	1,237	17.7

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Jun 10 & 08)		W't (%)	Dur'n (yrs)
Gilts (17)	235	167	90.7	14.4
< 5 Yrs (2)	36	14	14.0	2.2
5 – 15 Yrs (5)	93	78	36.0	8.7
> 15 Yrs (10)	105	75	40.7	23.7
Non Gilts (52)	24	17	9.3	17.7

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

Month End	US (%)	Euro (%)	Sterling (%)
Mar 10	7.73	7.58	9.48
Apr 10	7.54	7.51	9.31
May 10	8.45	8.92	10.43
Jun 10	**8.28**	**8.75**	**10.60**

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