



## Investment Update September 2010

### Investment Headlines & Comment

- New regulations require pension schemes to measure **indirect self-investment** (eg pooled funds).
- **Irish yields** jumped to 6.7% this month, but Greece is still over 10% and Germany at 2.3%.
- A strong rally in **Overseas equities** this month – with the Euro strengthening too.

### Feature Section

Following on from our September 2003 Update, in the next two editions of Update we examine how the characteristics of Emerging Market Debt (EMD) have changed and consider if there are currently any benefits to investing in EMD for institutional investors.

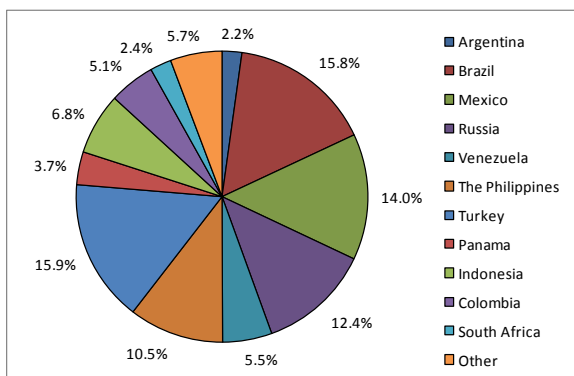
EMD refers to bonds issued by less-developed countries (but usually excludes loans from overseas governments and/or borrowing from supranational organizations such as the IMF or private sources). Traditionally, EMD has been viewed as a risky investment, with many EMD countries being rated below investment grade. This was largely justified due to political risk and high debt-to-GDP ratios that increased the risk of default, plus the numerous currency crises that impacted heavily on returns. Events such as the Russian financial crisis and subsequent default in 1998, and the Argentinean financial crisis in 2001 and subsequent default in 2002, also helped justify the continuance of this view. However, the impact of the credit crunch on European debt, such as for Greece, has led investors to consider whether the risk of default on developed markets is really less than on Emerging Markets.

The JP Morgan Emerging Market Bond Index Plus (EMBI+) is a widely used index that tracks the total returns for traded external debt instruments in the emerging markets (external meaning fixed income denominated in foreign currency, which is here restricted to US Dollar). The EMBI+ expands upon JP Morgan's original Emerging Markets Bond Index (EMBI), which was introduced in 1992 and covered only Brady bonds (Brady bonds are dollar-denominated bonds, issued mostly by Latin American countries in the 1980s, and named after U.S. Treasury Secretary Nicholas Brady). A further index called the EMBI Global covers more bonds than the EMBI+ by relaxing the strict EMBI+ limits on secondary market trading liquidity, but is still US Dollar only. The current breakdown of the EMBI+ index is shown in Figure 1a – the index is fairly concentrated with Brazil, Turkey, Mexico and Russia comprising over half of the index.

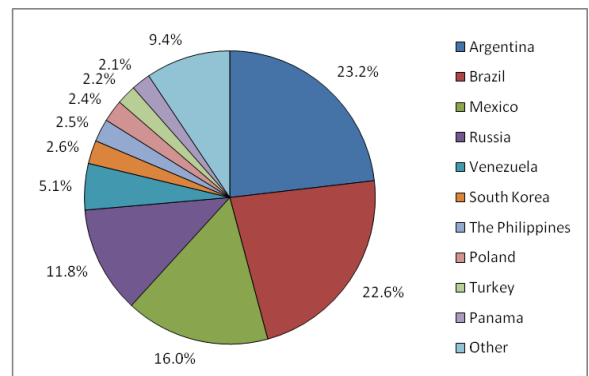
As at 30 September 2010, the EMBI+ had a market capitalisation (“market cap”) of US\$252bn, which compares to a market cap of US\$172bn as at January 2001 (i.e. prior to the Argentinean financial crisis in 2001). The breakdown of the EMBI+ index as at January 2001 is shown in Figure 1b – since then, the index has become slightly less concentrated. The EMBI+ market cap of US\$252bn compares with a market cap of US\$17,440bn for the whole JPMorgan Government Bond Index (GBI), which includes US\$5,388bn for the US, and US\$1,058bn for the UK. (Perversely, some EMBI+ countries can also be in the GBI – these are so-called “cross-over countries”, such as Korea, Mexico and South Africa.) Even when compared to the Global High Yield Indexes, the EMBI+ is small – as at 30 September 2010 the market cap of the JP Morgan Global High Yield Index was \$684bn.

Whilst the concentration of the EMBI+ in a small group of countries may be a concern for investors, it is still relevant to ask if the finances of the EM countries have improved and therefore whether the default risk on EMD has reduced. This is something we will consider next month when we also consider the yields being offered on EMD, and how these compare with those offered on alternative bond assets.

**Figure 1a: September 2010 profile**



**Figure 1b: January 2001 profile**





**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 September 2010**

Asset Class	1 month (%)	3 months (%)	12 months (%)	3 years (% p.a.)	5 years (% p.a.)	10 years (% p.a.)
UK Equities	6.5	<b>13.6</b>	12.5	-1.0	4.5	2.8
Overseas Equities	7.1	8.3	10.5	2.0	5.9	1.7
US Equities	6.3	5.7	11.8	1.5	3.3	-0.9
Europe ex UK Equities	<b>9.2</b>	13.3	2.3	-1.8	6.4	3.6
Japan Equities	1.8	<b>0.1</b>	1.2	-1.7	<b>-0.4</b>	<b>-2.4</b>
Pacific ex Japan Equities	<b>9.2</b>	12.6	20.3	7.0	15.5	11.9
Emerging Markets	8.4	12.2	22.3	7.8	<b>15.7</b>	<b>13.0</b>
UK Long-dated Gilts	<b>-1.2</b>	5.8	7.8	8.8	5.6	5.7
UK Long-dated Corp. Bonds	<b>-0.8</b>	6.9	12.4	7.8	4.6	6.8
UK Over 5 Yrs Index-Linked Gilts	0.5	4.1	9.5	7.6	6.4	6.3
High Yield (Global)	1.6	3.4	19.6	18.6	11.4	7.6
Overseas Bonds	<b>-0.3</b>	2.4	7.9	<b>19.1</b>	10.1	7.2
Property *	0.7	2.5	<b>23.9</b>	<b>-7.3</b>	1.2	6.5
Cash	0.1	0.2	<b>0.7</b>	3.0	3.9	4.2
Commodities £-converted	5.8	2.8	5.7	<b>-5.4</b>	<b>-8.1</b>	0.6
Hedge Funds original \$ basis *	0.0	0.6	6.7	0.7	4.9	5.5
Illustrative £-converted version *	1.8	<b>-4.9</b>	13.2	10.2	8.3	5.0
Euro relative to Sterling	4.8	5.8	<b>-5.2</b>	7.5	4.9	3.8
US \$ relative to Sterling	<b>-2.5</b>	<b>-5.1</b>	1.5	9.1	2.3	<b>-0.6</b>
Japanese Yen relative to Sterling	<b>-1.9</b>	0.6	8.8	21.2	8.8	2.0
Price Inflation (RPI) *	0.4	0.4	4.7	2.7	3.1	2.8
Price Inflation (CPI) *	0.5	0.4	3.1	3.1	2.7	2.2
Price Inflation (RPIX) *	0.4	0.4	4.7	3.8	3.5	2.9
Earnings Inflation **	<b>-1.0</b>	0.2	1.9	1.8	2.9	3.5
All Share Capital Growth	6.3	12.7	8.8	<b>-4.7</b>	0.9	<b>-0.5</b>
Net Dividend Growth	0.0	7.0	3.6	<b>-1.8</b>	2.1	3.3
Earnings Growth	0.3	2.8	33.7	<b>-8.8</b>	2.0	5.1

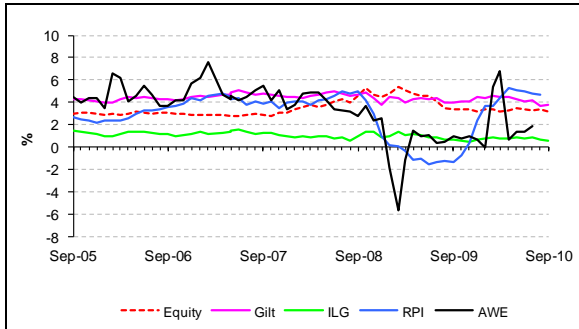
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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.

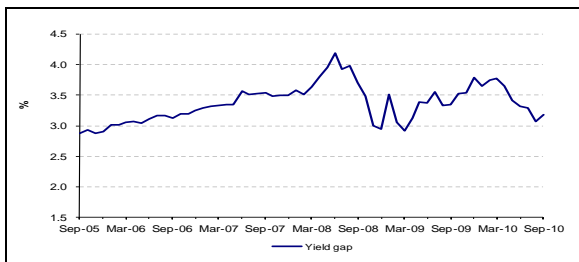


## Yields and Yield Gaps

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.

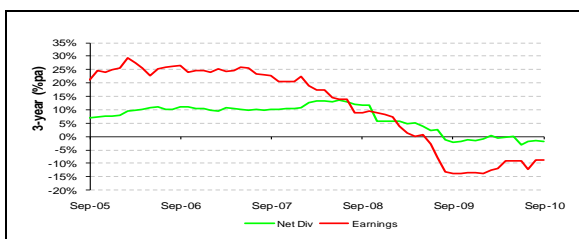
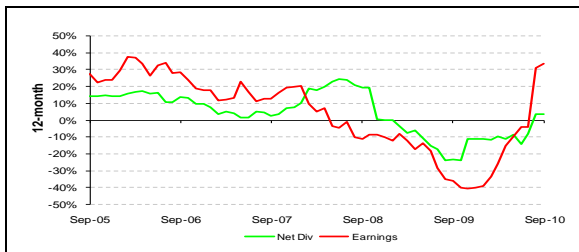


The gap gives expectations just over 3% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

## 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]

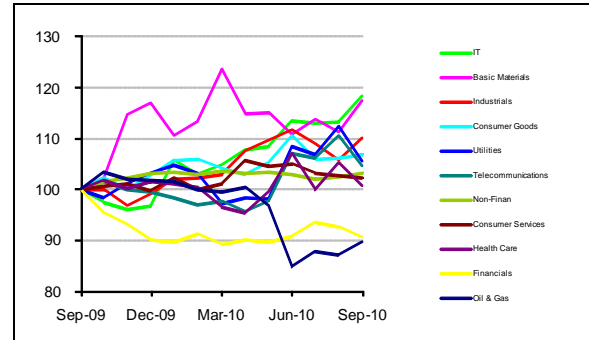
Figure 3: Dividend & Earnings Growth



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



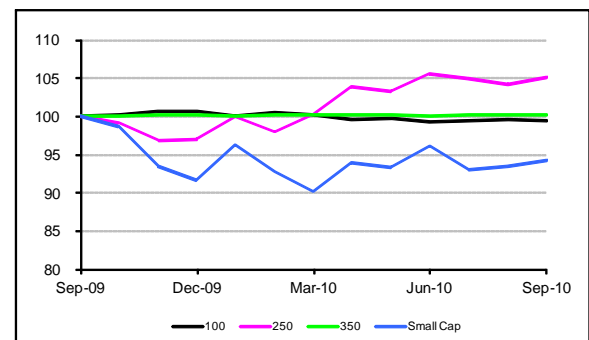
Note: Sector labels for relative lines are in end-value order

A fall this month in the rolling 12-month sector dispersion (down slightly from 32% to 29%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	9.7	20.2	0.9
Basic Materials	12.4	20.5	32.0
Industrials	11.0	11.9	23.8
Consumer Goods	7.2	9.8	20.1
Health Care	1.9	6.8	13.1
Consumer Services	6.0	10.6	15.0
Telecommunications	0.8	11.0	17.6
Utilities	-0.1	10.3	18.6
Non-Finan	7.3	13.8	16.1
Financials	4.1	13.1	1.7
IT	11.2	18.4	33.0
All Share	6.5	13.6	12.5

## UK Equity Size Returns

Figure 4b: Size groups relative to All Share



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

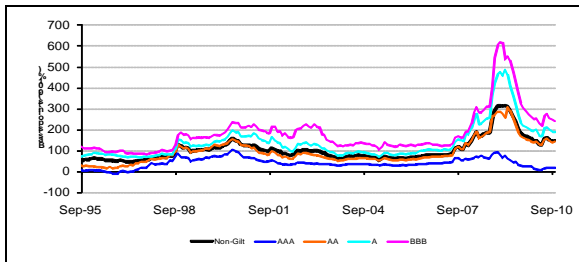
## FRS17 volatility indicator

Now discontinued, but available on request.



Bond market information

Figure 5: £ Non-Gilt Credit Margins



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

£ Gilt Market “main” Issuance

- £4.12bn 5% 2014 (1.69x, 1.54%, prev Jun 10)
- £3.30bn 3¾% 2020 (1.68x, 3.22%, Jul 10)
- £2.00bn 4¾% 2030 (1.49x, 3.95%, Oct 09)
- £1.00bn 4¾% 2038 (1.56x, 3.84%, May 09)
- £0.55bn ILG 1¼% 2027 (2.23x, r.y. 0.67%, Aug 10)
- £0.88bn ILG ¾% 2047 (2.04x, r.y. 0.57%, Jul 10)

Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y’ld (%)	FT 20 yr Gilt (%)	Margin (%)
Apr 10	5.38	4.44	0.94
May 10	5.39	4.25	1.14
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	<b>4.89</b>	<b>3.77</b>	<b>1.12</b>

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

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (256)	4,061	58.1
Non Sovereigns	2,926	41.9
AAA (646)	1,299	18.6
AA (412)	602	8.6
A (618)	677	9.7
BBB (407)	347	5.0

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

Category	Mkt Val (£bn @ Sep 10 & 08, 06)			Weight (%)
Gilts (34)	816	377	310	62.5
Non Gilts (1,020)	489	407	395	37.5
AAA (180)	147	148	149	11.3
AA (175)	75	70	64	5.7
A (393)	171	127	119	13.1
BBB (272)	96	60	59	7.4

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (692)	1,915	27.4
3 – 5 Yrs (697)	1,654	23.7
5 – 7 Yrs (400)	968	13.9
7 – 10 Yrs (330)	1,146	16.4
10+ Yrs (220)	1,303	18.7

Category	Mkt Val (£bn @ Sep 10, 08)		W’t (%)	Dur’n (yrs)
Gilts (34)	816	377	62.5	9.2
< 5 Yrs (8)	217	105	16.6	2.6
5–15 Yrs (12)	313	119	24.0	7.1
> 15 Yrs (14)	286	153	21.9	16.3
Non Gilts (1,020)	489	407	37.5	7.4
< 5 Yrs (259)	137	136	10.5	2.3
5–15 Yrs (477)	212	156	16.2	6.9
> 15 Yrs (284)	140	115	10.8	13.1

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Sep 10 & 08)		W’t (%)	Dur’n (yrs)
Gilts (16)	239	170	90.6	15.8
< 5 Yrs (1)	21	33	8.1	2.8
5 – 15 Yrs (5)	97	59	36.7	8.6
> 15 Yrs (10)	121	78	45.8	23.8
Non Gilts (49)	25	17	9.4	17.9

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

Month End	US (%)	Euro (%)	Sterling (%)
Jun 10	8.28	8.75	10.60
Jul 10	7.70	7.83	9.59
Aug 10	7.74	7.73	9.29
Sep 10	<b>7.31</b>	<b>7.16</b>	<b>8.56</b>

