



Investment Update February 2011

Investment Headlines & Comment

- **Portugal** is the latest Euro member to see debt yields rising to new heights – now at levels last seen in 1996 in the pre-Euro era.
- **ING's** UK property investment firm (including their pooled fund-of-funds, Osiris) is going to **CB Richard Ellis**.
- **Sterling** has strengthened this month, as investors anticipate rises in interest rates, but 3-year gilt strips still yield below 2%.

Feature Section

In this month's *Update* we consider whether it is time for investors to exit some parts (but not necessarily all) of the High Yield bond market. This starts from revisiting the methodology in our December 2008 *Update*, where we established trade-off curves between default rates and recovery rates, associated with a set of given gilt and corporate bond market yields.

This analysis simply takes a 1-year view and says that if gilts and corporates are priced correctly, then (assuming no liquidity distortions) the credit margin will be just sufficient to compensate for the increased occurrence of default, allowing for any recovery of assets when the bond defaults. It can be expressed through one example equation, but it's not too scary so here it is again, both in "algebra", and derived from "general reasoning" on what you would accumulate by investing £1 in either gilts or corporates.

$$\begin{aligned}
 (1 + \text{Gilt Yield}) &= (1 + \text{Corporate Yield}) \times (1 - \text{Default Rate}) + (\text{Recovery Rate}) \times (\text{Default Rate}) \\
 \text{"Play safe"} &= \text{"take risk but avoid default so earn the yield"} + \text{"take risk, get default not yield, but earn the recovery rate"}
 \end{aligned}$$

The charts below (*Sources: FI, iBoxx, J&A, MLX*) show the current "trade-off" curves as well as the original pair of dates used in December 2008, for investment grade and sub-investment grade ("High Yield") corporate bonds. As Figure 5 on page 4 of *Update* shows, the credit margin for investment grade over government bonds remains well above historical averages, so it should not be a surprise that Figure 1a shows the current curve is still to the right of the pre-credit-crunch curve, but Figure 1b shows the US High Yield market is essentially back at its pre-credit-crunch profile.

Figure 1a: Investment Grade

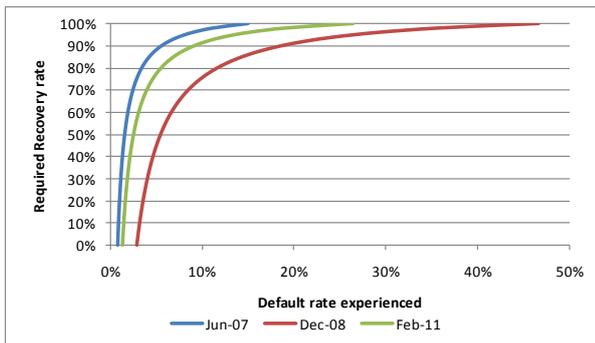
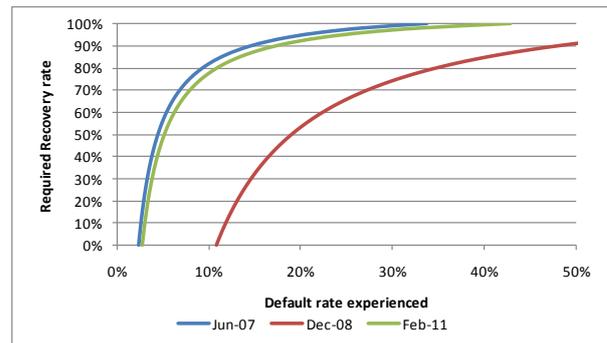
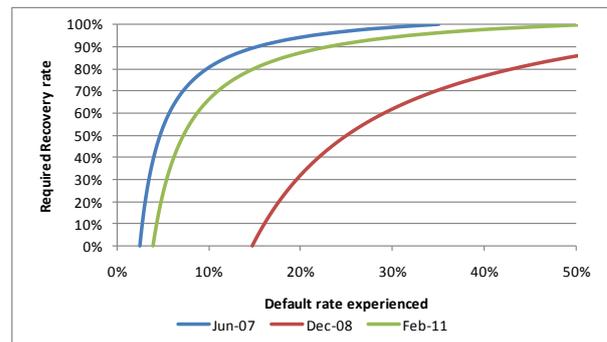


Figure 1b: High Yield (US denominated)



Standard and Poors provide analysis of global default rates to the end of 2009 (their release covering data to the end of 2010 is due later this month). From these "trade-off" charts we can infer that no recovery rate is needed at all for Investment Grade to match or exceed gilt returns if past default rates continue (averaging below 0.2% pa). However, a recovery rate of just over 30% would be needed for US High Yield to exceed gilts if past default rates continue (averaging 4.4% pa). This is quite high, and default rates could well exceed their past levels, so it does prompt investors to consider whether there is now too much unrewarded risk here, and hence that it could be time to withdraw from the US High Yield area.

Figure 1c: High Yield (Sterling denominated)



Fortunately, Figure 1c shows that the Sterling High Yield market is not yet back at its pre-credit-crunch profile, so for those who are concerned that US-centric bond funds do not offer sufficient risk-return comfort (even if currency hedged back into Sterling), the Sterling market may allow investors exposure to the High Yield asset class for a while longer.



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 28 February 2011

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	2.4	9.1	17.0	4.9	4.7	4.2	8.8
Overseas Equities	1.2	7.3	14.1	7.8	5.9	3.8	8.2
US Equities	1.8	8.0	14.4	9.5	4.7	1.5	10.0
Europe ex UK Equities	1.4	13.1	14.4	3.3	5.8	4.9	9.7
Japan Equities	3.1	8.0	9.6	5.0	-1.0	1.0	1.0
Pacific ex Japan Equities	-3.3	-1.0	14.3	9.4	13.1	12.0	10.7
Emerging Markets	-2.4	-1.1	13.4	7.7	11.6	13.8	10.8
UK Long-dated Gilts	1.6	-1.2	7.8	4.9	3.0	4.6	8.7
UK Long-dated Corp. Bonds	1.3	0.7	8.4	6.7	2.5	5.6	-
UK Over 5 Yrs Index-Linked Gilts	1.7	1.8	9.1	5.0	5.4	6.0	7.7
High Yield (Global)	0.0	2.0	9.8	20.2	11.3	7.3	-
Overseas Bonds	-1.3	-2.6	-1.3	12.3	9.1	5.9	7.7
Property *	0.7	2.2	13.4	-2.5	0.2	6.5	8.0
Cash	0.1	0.2	0.7	2.2	3.6	4.0	5.6
Commodities £-converted	2.1	11.9	12.2	-8.1	-1.7	1.9	5.2
Hedge Funds original \$ basis *	0.4	3.7	11.7	3.4	5.3	6.6	12.3
Illustrative £-converted version *	-1.8	3.5	11.7	11.2	7.5	5.6	13.4
Euro relative to Sterling	-0.8	1.5	-5.3	3.6	4.5	2.9	-
US \$ relative to Sterling	-1.5	-4.3	-6.5	6.9	1.5	-1.2	0.8
Japanese Yen relative to Sterling	-1.6	-2.1	1.5	15.8	8.8	2.4	3.3
Price Inflation (RPI) *	0.3	1.4	5.1	3.0	3.4	3.0	2.9
Price Inflation (CPI) *	0.1	1.5	4.0	3.5	3.1	2.3	2.3
Price Inflation (RPIX) *	0.3	1.5	5.1	4.0	3.8	3.1	3.0
Earnings Inflation **	2.2	1.9	1.1	1.4	2.7	3.1	3.8
All Share Capital Growth	2.0	8.6	13.5	1.0	1.0	0.8	5.1
Net Dividend Growth	1.3	1.5	-2.1	-5.9	0.5	2.8	-
Earnings Growth	7.9	8.1	60.8	-0.6	3.7	7.1	-

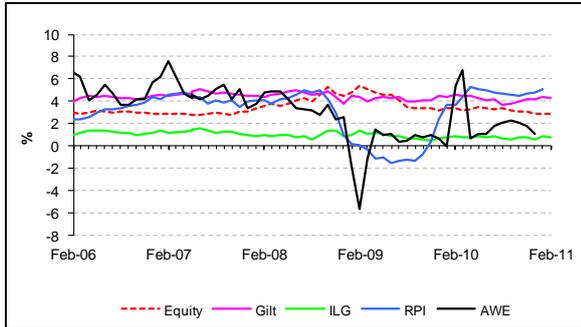
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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.

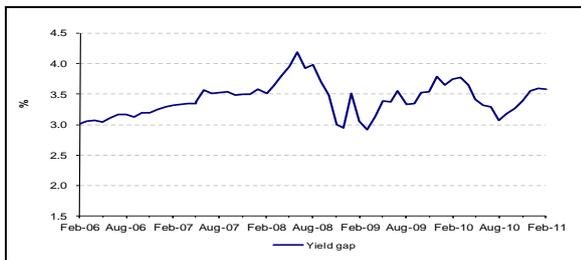


Yields and Yield Gaps

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.

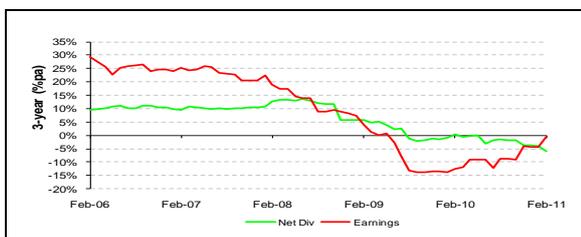
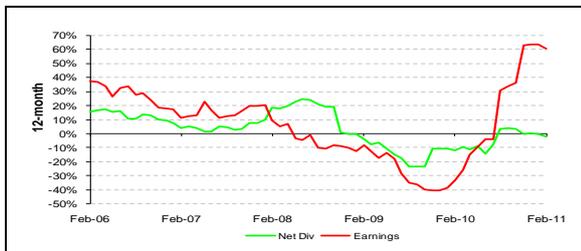


The gap gives expectations of just over 3.5% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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]

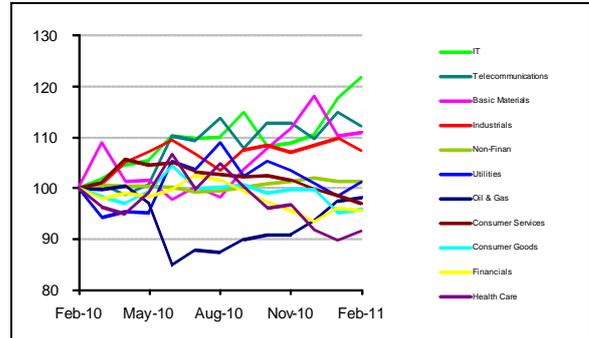
Figure 3: Dividend & Earnings Growth



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

A slight rise this month in the rolling 12-month sector dispersion (up from 26% to 30%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	3.1	17.9	14.7
Basic Materials	3.1	8.5	29.8
Industrials	-0.0	9.2	25.4
Consumer Goods	3.1	4.8	12.0
Health Care	4.5	3.0	6.9
Consumer Services	0.7	4.2	13.5
Telecommunications	0.0	8.5	31.3
Utilities	5.3	6.7	18.4
Non-Finan	2.5	9.1	18.6
Financials	2.0	9.2	11.9
IT	6.1	22.1	42.4
All Share	2.4	9.1	17.0

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Mid and Small Cap fell in relative terms this month.

FRS17 volatility indicator

Now discontinued, but available on request.



Bond market information

Figure 5: £ Non-Gilt Credit Margins

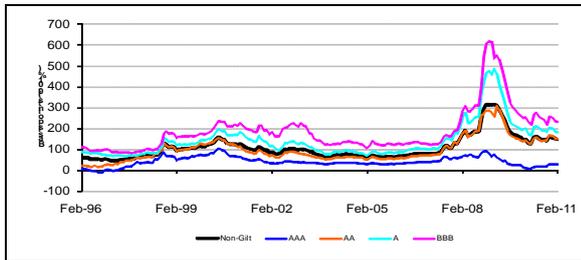


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
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	5.35	4.14	1.21
Jan 11	5.50	4.39	1.11
Feb 11	5.45	4.31	1.14

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

Category	Mkt Val (£bn @ Feb 11 & 09, 07)			Weight (%)
Gilts (34)	812	545	317	64.0
Non Gilts (1,019)	457	387	412	36.0
AAA (179)	125	142	149	9.8
AA (173)	72	55	67	5.7
A (388)	162	129	125	12.8
BBB (279)	98	59	68	7.7

Category	Mkt Val (£bn @ Feb 11, 09)		W't (%)	Dur'n (yrs)
Gilts (34)	812	545	64.0	8.8
< 5 Yrs (10)	261	155	20.5	2.8
5-15 Yrs (10)	269	183	21.2	7.3
> 15 Yrs (14)	283	207	22.3	15.8
Non Gilts (1,019)	457	387	36.0	7.4
< 5 Yrs (265)	124	135	9.8	2.6
5-15 Yrs (467)	197	140	15.6	6.8
> 15 Yrs (287)	136	112	10.7	12.7

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

£ Gilt Market “main” Issuance

- £3.75bn 2% 2016 (1.93x, 2.70%, prev Dec 10)
 - £3.03bn 3¾% 2020 (2.06x, 3.89%, Jan 11)
 - £2.16bn 4¼% 2040 (1.87x, 4.52%, Oct 10)
 - £1.05bn ILG 1⁷/₈% 2022 (1.86x, r.y 0.83%, Jul 10)
- Note: ILG issuance amounts are nominals

Tables 2d, 2e: € Market Size and Maturity (Feb 11)

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (259)	3,929	58.0
Non Sovereigns	2,851	42.0
AAA (655)	1,228	18.1
AA (426)	588	8.7
A (646)	678	10.0
BBB (437)	356	5.3

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (730)	1,924	28.4
3 – 5 Yrs (679)	1,553	22.9
5 – 7 Yrs (436)	978	14.4
7 – 10 Yrs (351)	1,117	16.5
10+ Yrs (227)	1,207	17.8

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Feb 11 & 09)		W't (%)	Dur'n (yrs)
Gilts (16)	251	165	91.1	15.9
< 5 Yrs (1)	21	33	7.8	2.4
5 – 15 Yrs (5)	99	59	35.9	8.2
> 15 Yrs (10)	131	74	47.4	23.9
Non Gilts (49)	25	17	8.9	17.5

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

Month End	US (%)	Euro (%)	Sterling (%)
Oct 10	7.04	7.10	8.67
Nov 10	7.40	8.21	9.70
Dec 10	7.24	7.53	8.60
Jan 11	6.95	7.39	8.55
Feb 11	6.83	7.18	8.09

