



Investment Update March 2011

Investment Headlines & Comment

- Triggered by Middle East instability, the **price of crude oil** jumped by 10% this month and is up 17% so far this year. Other oil commodities are up by even more.
- An increased gap between **RPI and CPI** inflation is expected (averaging 1.2% p.a. for the next five years) according to the Office of Budget Responsibility.
- As the Euro crisis continues **Greece, Ireland and Portugal** hit new Euro-highs for their bond yields (10-year bonds now above 12.5%, 10% and 8% respectively).

Feature Section

In this month's *Update* we return to the UK commercial property market, to consider its total return, the capital component thereof, and how this compares with the capital return on UK residential property. For commercial property, we use the IPD Monthly Index series, and for residential property we use the Halifax (seasonally adjusted) "all houses, all buyers" index.

It has been rare for pension funds to invest in residential property, partly because of the small unit sizes, issues on the potential lack of vacant possession, and the greater element of property management required on residential tenants than for properties in the commercial sector. We considered residential property for a pension fund client whose associated employer is linked to the UK house building sector. They were interested in the extent (if any) of diversification between the commercial property held by the pension fund, and the residential property exposure of the employer's business. However, it is also of potential interest to other investors, for example universities may own (or look to acquire) student accommodation although their associated endowment funds may have historically focused on commercial property.

The IPD index started in December 1986, and measures un-gearred total returns for directly-held standing property investments from one open market valuation to the next. This currently involves 3,628 properties with a market value of £33bn. In the first few years of the IPD index, the UK commercial property market rose very strongly ahead of inflation (although this is not immediately obvious from Figure 1a below, until you notice the vertical scale). Even after the gyrations from early 2007, it remains that over the period to February 2011, the IPD index has still given a good total return over inflation, at 5.1% p.a. since inception, but once the income component is stripped out of this return, you reach the slightly startling conclusion that the capital value of the IPD index has *fallen* in real terms by an average of 1.8% p.a., possibly due to depreciation and/or rising property maintenance costs. This is in contrast to the Halifax's residential capital index, which has risen in real terms by 2% p.a. over the period – and which in turn is consistent with the notion that the residential property market remains expensive. The real divergence in the capital values came in the early 2000s, when the housing property bubble took hold. (Add, say, 5% to the capital return for an indicative total return for the residential index.)

Figure 1a: Cumulative real returns (rebased to 100)

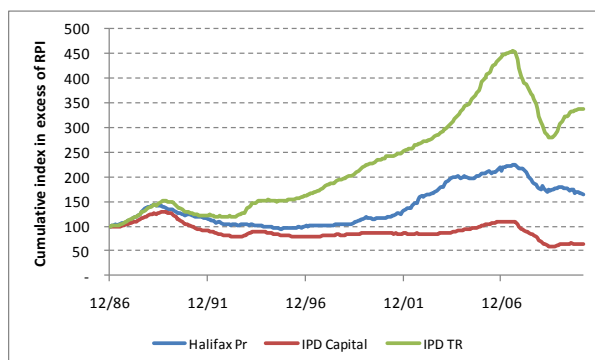
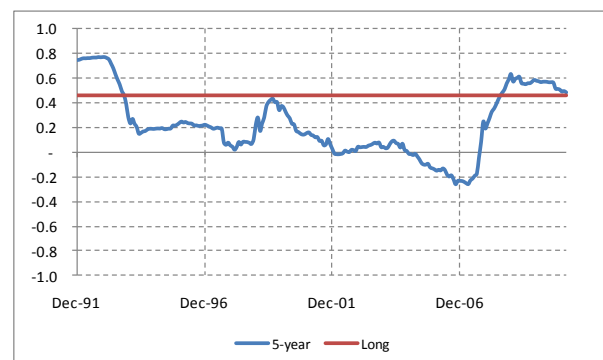


Figure 1b: Rolling 5-year correlation



We can see from Figure 1a that there have been long periods where the IPD capital index has stayed comparatively flat or has declined in real terms, and indeed that applies at the moment with nominal capital values being almost stationary. (The income component on the IPD index remains appealing at about 6.8%, although this is before fund manager costs). On the bright side, Figure 1b shows that for much of the period, there has been comparatively low correlation between UK residential and commercial property, which suggests that if an attractively-priced (and practical) residential opportunity presents itself to an institutional investor, then even with the caveat about greater management being involved, it could be a useful complement to that investor's commercial portfolio.



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 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	-0.8	1.0	8.7	5.4	3.7	4.7	8.6
Overseas Equities	1.7	2.1	8.5	8.9	5.6	4.6	8.0
US Equities	1.5	3.3	9.2	10.3	4.5	2.3	10.0
Europe ex UK Equities	1.8	6.0	8.2	3.4	5.1	5.9	9.2
Japan Equities	-7.6	-6.9	-4.0	3.6	-3.3	0.4	0.5
Pacific ex Japan Equities	6.8	-0.5	13.1	14.0	14.0	13.9	10.5
Emerging Markets	7.5	-0.3	12.4	12.4	12.8	15.6	10.6
UK Long-dated Gilts	0.7	-1.5	6.9	5.1	3.8	4.9	8.7
UK Long-dated Corp. Bonds	0.6	0.2	6.1	7.3	3.2	5.7	-
UK Over 5 Yrs Index-Linked Gilts	0.8	-0.2	6.7	4.6	5.9	6.4	7.7
High Yield (Global)	2.2	2.4	8.1	21.1	11.3	7.7	-
Overseas Bonds	1.8	-1.9	2.1	11.8	9.6	6.3	7.5
Property *	0.7	2.3	12.1	-1.9	0.0	6.5	8.1
Cash	0.1	0.2	0.7	2.1	3.5	4.0	5.6
Commodities £-converted	5.9	9.0	16.1	-5.9	-1.8	2.8	4.8
Hedge Funds original \$ basis *	1.2	4.6	12.2	3.3	5.4	7.0	12.1
Illustrative £-converted version *	-0.4	0.1	4.9	10.4	7.0	5.7	13.0
Euro relative to Sterling	4.2	3.3	-0.8	3.5	4.9	3.6	-
US \$ relative to Sterling	1.5	-2.3	-5.4	7.4	1.6	-1.2	0.4
Japanese Yen relative to Sterling	0.3	-4.4	6.6	14.2	9.0	3.0	3.1
Price Inflation (RPI) *	1.0	2.0	5.5	3.0	3.6	3.0	2.9
Price Inflation (CPI) *	0.8	1.9	4.3	3.5	3.1	2.4	2.4
Price Inflation (RPIX) *	1.0	2.0	5.5	4.1	3.9	3.2	3.0
Earnings Inflation **	1.8	4.4	3.9	0.7	2.4	3.4	4.0
All Share Capital Growth	-1.3	0.2	5.4	1.6	0.1	1.2	4.8
Net Dividend Growth	1.1	2.6	-1.3	-6.2	0.5	2.8	-
Earnings Growth	-15.7	-8.9	30.3	-5.5	0.0	4.9	-

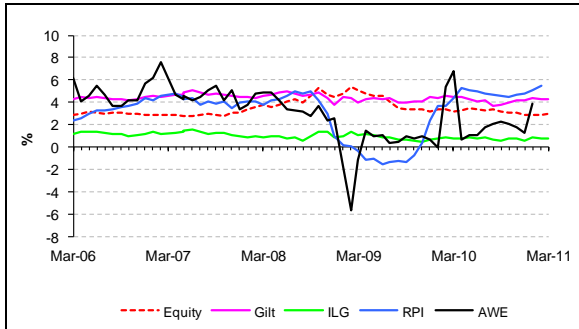
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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.

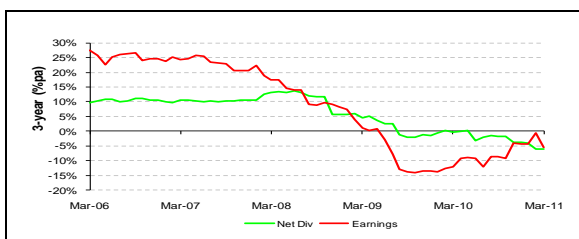
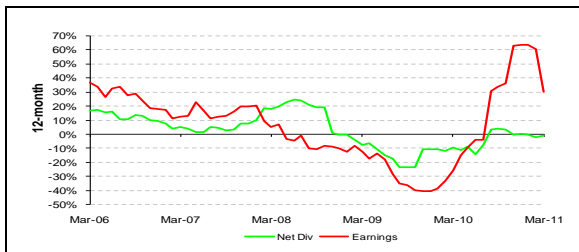


The gap gives expectations of just over 3.5% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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]

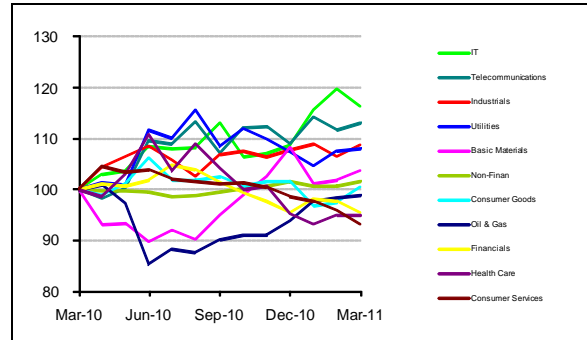
Figure 3: Dividend & Earnings Growth



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



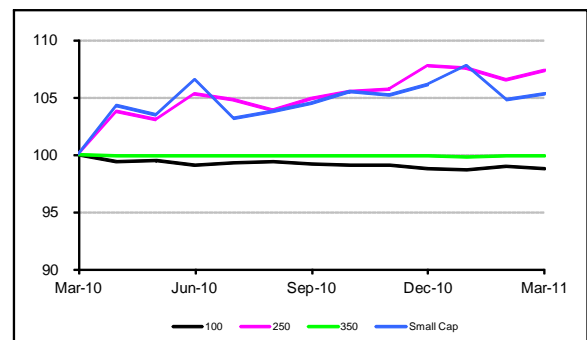
Note: Sector labels for relative lines are in end-value order

A marked fall this month in the rolling 12-month sector dispersion (down from 30% to 23%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	-0.5	6.3	7.4
Basic Materials	0.9	-3.3	12.6
Industrials	1.4	2.0	18.2
Consumer Goods	2.3	0.0	9.3
Health Care	-0.9	0.7	3.1
Consumer Services	-3.7	-4.7	1.2
Telecommunications	0.4	4.8	22.8
Utilities	-0.3	1.7	17.4
Non-Finan	-0.1	1.0	10.3
Financials	-3.2	1.0	3.7
IT	-3.8	8.0	26.3
All Share	-0.8	1.0	8.7

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Mid and Small Cap rose in relative terms this month.

FRS17 volatility indicator

Now discontinued, but available on request.



Bond market information

Figure 5: £ Non-Gilt Credit Margins

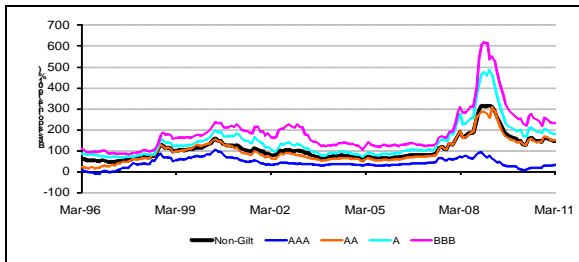


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
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
Mar 11	5.46	4.31	1.15

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

Category	Mkt Val (£bn @ Mar 11 & 09, 07)			Weight (%)
Gilts (34)	815	587	310	63.7
Non Gilts (1,027)	464	399	405	36.3
AAA (183)	129	142	146	10.1
AA (173)	72	60	66	5.6
A (387)	162	134	123	12.7
BBB (284)	100	61	67	7.8

Category	Mkt Val (£bn @ Mar 11, 09)		W't (%)	Dur'n (yrs)
Gilts (34)	815	587	63.7	8.8
< 5 Yrs (10)	261	168	20.4	2.8
5-15 Yrs (10)	268	196	21.0	7.3
> 15 Yrs (14)	286	223	22.3	15.7
Non Gilts (1,027)	464	399	36.3	7.4
< 5 Yrs (266)	126	143	9.9	2.6
5-15 Yrs (476)	201	144	15.8	6.8
> 15 Yrs (285)	136	112	10.7	12.8

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

£ Gilt Market “main” Issuance

- £4.34bn 2% 2016 (1.79x, 2.65%, prev Feb 11)
 - £2.75bn 3¾% 2021 (2.01x, 3.66%, new)
 - £2.48bn 4¼% 2055 (1.72x, 4.34%, Feb 09)
 - £0.87bn ILG 5/8% 2042 (2.80x, r.y 0.71%, Dec 10)
- Note: ILG issuance amounts are nominals

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

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (262)	3,928	57.9
Non Sovereigns	2,852	42.1
AAA (672)	1,251	18.5
AA (420)	572	8.4
A (644)	661	9.8
BBB (446)	368	5.4

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (750)	1,943	28.7
3 – 5 Yrs (670)	1,560	23.0
5 – 7 Yrs (440)	978	14.4
7 – 10 Yrs (353)	1,088	16.1
10+ Yrs (231)	1,210	17.9

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Mar 11 & 09)		W't (%)	Dur'n (yrs)
Gilts (16)	254	176	91.1	15.9
< 5 Yrs (1)	22	33	7.8	2.3
5 – 15 Yrs (5)	99	61	35.6	8.2
> 15 Yrs (10)	133	82	47.7	23.9
Non Gilts (49)	25	18	8.9	17.4

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

Month End	US (%)	Euro (%)	Sterling (%)
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
Mar 11	6.86	7.57	8.28

