



Investment Update June 2011

Investment Headlines & Comment

- A bad month for **Sterling**, particularly against the Euro.
- Some **Greek austerity** is in place but no major bond yield falls yet.
- Consultation has started on whether to issue **CPI-linked gilts**.

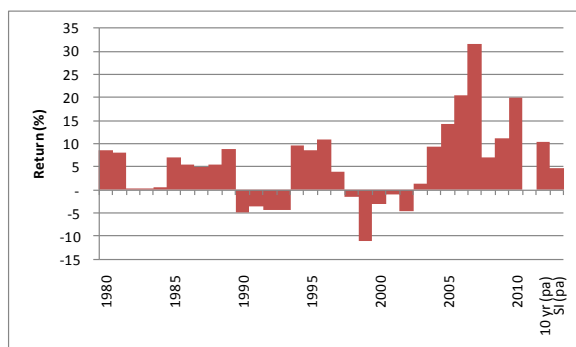
Feature Section

During the “credit crunch”, investors in some illiquid asset classes suffered heavy losses, after long periods of strong returns. This month, we consider an illiquid asset class which thrived – Forestry, or as our US cousins term it, Timberland. Returns on forestry come from the sale of timber (standing or felled), other goods and services (latterly increasing in importance, due to wind farms), changes in the value of the land, and from subsidies (e.g. planting grants), but returns are reduced by costs of employees and machinery (and tax relief on this ceased in 1992). Within the UK tax system, timber sales are free from Income and Corporation Tax, and growing timber is exempt from Capital Gains Tax, plus there are some Inheritance Tax exemptions, so returns can be distorted by “retail investors” (as has been seen with some VCTs).

In the UK, the IPD Forestry Index is calculated each March (but labeled for the previous calendar year) from a sample of private sector coniferous plantations of predominantly Sitka spruce in mainland Britain. The sample originally reflected market cap across the regions and a broadly even number of plantations by age band in each region. This has been distorted over the years by the ageing of plantations, and there is also a wide dispersion of returns across plantations. By the end of 2010 the 144 forests in the index had a total capital value of £148m. Figure 1a shows the peculiar profile of the annual returns – blocks of modest good years, alternating with blocks of modest bad years, and then a sea change in the mid 2000s, perhaps because Government subsidies for wind farms (even if only for output, rather than construction) made the sector an extremely appealing investment prospect. Since inception it has returned 4.8% p.a. but over the last 10 years the return has been rather higher at 10.4% p.a.

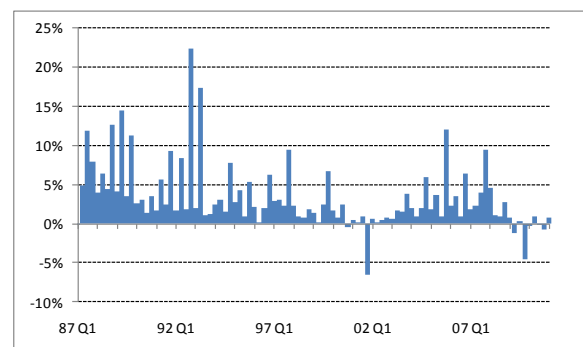
In the US, the NCREIF Timberland Index is a quarterly index based on a large pool of individual timber properties held for investment purposes only, and at least in part on behalf of tax-exempt institutional investors - the great majority being pension funds. Figure 1b below shows the Index’s *quarterly* returns – since its inception (somewhat later than the IPD) it has returned 13.4% p.a. but over the last 10 years the return has been rather lower at 6.8% p.a.

Figure 1a: UK IPD Forestry Index



Source: IPD

Figure 1b: NCREIF Timberland Index



Source: NCREIF

For those investors looking for pooled fund exposure to Forestry, the easiest route is iShares, which offers an exchange traded fund (ETF) that aims to track the performance of the S&P Global Timber & Forestry Index as closely as possible. The ETF invests in the 25 largest and most liquid listed companies globally that are involved in the ownership, management or the upstream supply chain of forests and timberlands. The index is weighted by modified market capitalisation. However, as with Property and other alternative investments, the use of an ETF does introduce some general equity market volatility versus having direct forestry holdings.

Direct investors may well draw comfort that occasional sales of forest areas achieve or exceed the valuations placed on them. However, with these performance figures, there is the caveat that the assets are not instantly realizable in the way that, say, a portfolio of mainstream equities might be. It is arguable that an investor trying to exit in a “forced seller” situation could find themselves bearing a significant one-off hit on realization. Indeed, the price history of the iShares ETF suggests a hit of 10% or more, so selling the physical asset could easily be worse.



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 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	-0.5	1.9	25.6	6.6	4.5	4.8	8.7
Overseas Equities	1.1	0.2	21.5	9.7	7.2	4.1	7.7
US Equities	0.8	0.0	21.8	11.2	6.1	1.6	10.0
Europe ex UK Equities	1.3	2.6	29.5	5.8	6.6	6.4	8.8
Japan Equities	4.2	0.2	5.4	2.9	-1.1	0.1	0.4
Pacific ex Japan Equities	0.6	-0.1	21.3	15.9	15.4	13.2	9.9
Emerging Markets	1.0	-1.2	19.5	12.3	14.9	15.0	9.7
UK Long-dated Gilts	-2.1	2.3	2.8	7.3	4.8	5.6	8.8
UK Long-dated Corp. Bonds	-2.3	1.3	4.3	8.2	4.0	6.0	-
UK Over 5 Yrs Index-Linked Gilts	0.7	4.5	9.7	5.7	7.0	6.9	7.9
High Yield (Global)	1.5	1.1	10.1	20.9	12.8	8.0	-
Overseas Bonds	2.9	3.2	2.6	14.7	11.0	6.7	7.3
Property *	0.7	2.3	9.4	-0.5	-0.5	6.5	8.2
Cash	0.1	0.2	0.8	1.7	3.3	3.8	5.4
Commodities £-converted	-2.9	-8.1	17.5	-15.8	-3.5	2.3	4.0
Hedge Funds original \$ basis *	-1.1	0.3	11.8	3.0	5.0	6.9	11.7
Illustrative £-converted version *	0.2	-0.8	-1.3	9.5	7.7	5.3	11.9
Euro relative to Sterling	3.4	2.1	10.3	4.5	5.5	4.1	-
US \$ relative to Sterling	2.6	-0.1	-6.8	7.4	2.9	-1.3	0.0
Japanese Yen relative to Sterling	3.1	2.5	2.1	17.6	10.3	3.1	2.8
Price Inflation (RPI) *	0.3	1.7	5.2	3.0	3.5	3.0	2.9
Price Inflation (CPI) *	0.2	1.4	4.5	3.3	3.2	2.4	2.2
Price Inflation (RPIX) *	0.3	1.7	5.3	4.0	3.9	3.1	3.0
Earnings Inflation **	-11.3	-2.5	2.1	1.4	2.6	3.1	3.8
All Share Capital Growth	-0.8	0.9	21.7	2.7	0.9	1.3	5.0
Net Dividend Growth	-0.1	2.0	9.0	-7.4	0.1	3.4	-
Earnings Growth	0.0	19.3	32.9	1.5	3.1	7.1	-

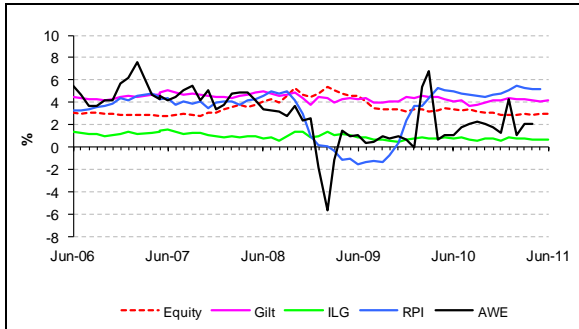
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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.

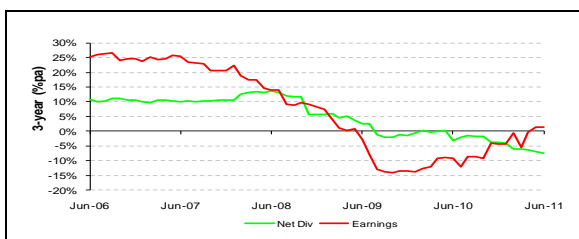
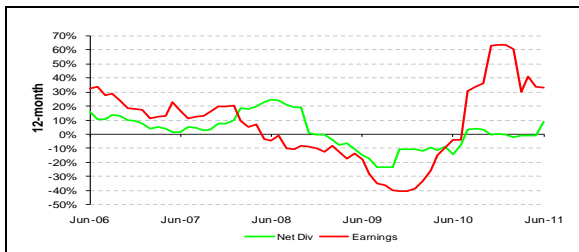


The gap gives expectations of just over 3.5% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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]

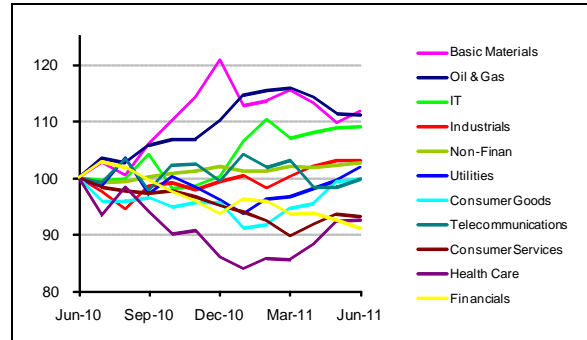
Figure 3: Dividend & Earnings Growth



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



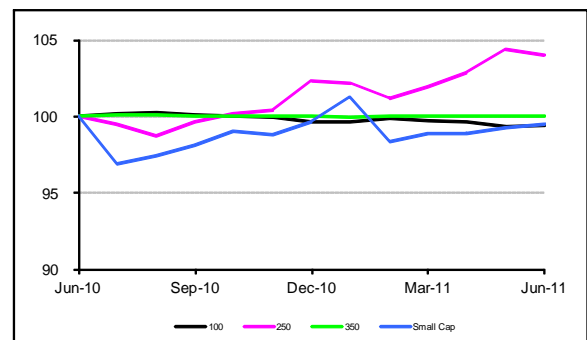
Note: Sector labels for relative lines are in end-value order

There was a small rise this month in the rolling 12-month sector dispersion (up from 20% to 21%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	-0.8	-2.3	39.5
Basic Materials	1.4	-1.4	40.5
Industrials	-0.5	4.8	29.5
Consumer Goods	-0.1	7.4	25.4
Health Care	-0.2	10.3	16.4
Consumer Services	-0.9	5.9	17.1
Telecommunications	1.0	-1.3	25.4
Utilities	1.8	7.3	27.9
Non-Finan	0.0	2.7	29.2
Financials	-2.1	-0.7	14.5
IT	-0.3	3.8	37.0
All Share	-0.5	1.9	25.6

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Mid Cap fell but 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

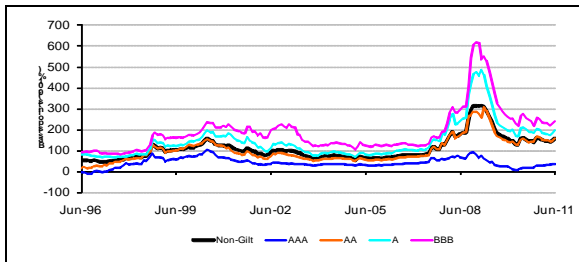


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
Jan 11	5.50	4.39	1.11
Feb 11	5.45	4.31	1.14
Mar 11	5.46	4.31	1.15
Apr 11	5.26	4.14	1.12
May 11	5.26	4.06	1.20
June 11	5.54	4.21	1.33

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

Category	Mkt Val (£bn @ June 11 & 09, 07)			Weight (%)
Gilts (34)	832	603	299	64.0
Non Gilts (1,027)	469	440	410	36.0
AAA (179)	128	145	147	9.9
AA (170)	73	62	65	5.6
A (386)	163	146	128	12.6
BBB (292)	105	84	68	8.0

Category	Mkt Val (£bn @ Jun 11, 09)		W't (%)	Dur'n (yrs)
Gilts (34)	832	603	64.0	8.9
< 5 Yrs (9)	251	152	19.3	2.8
5-15 Yrs (11)	287	219	22.0	7.1
> 15 Yrs (14)	294	231	22.6	15.9
Non Gilts (1,027)	469	440	36.0	7.5
< 5 Yrs (256)	121	149	9.3	2.7
5-15 Yrs (485)	211	168	16.2	6.8
> 15 Yrs (286)	138	122	10.6	12.8

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

£ Gilt Market “main” Issuance

- £4.75bn 2% 2016 (1.56x, 1.96%, prev April 11)
- £3.60bn 3¾% 2021 (1.60x, 3.42%, April 11)
- £2.47bn 4¼% 2027 (1.85x, 4.00%, Oct 10)
- £5.00bn 4% 2060 (1.91x, 4.15%, Feb 10)
- £1.00bn ILG 5/8% 2040 (2.33x, r.y 0.59%, July 10)
- £0.45bn ILG ½% 2050 (2.17x, r.y 0.50%, April 11)

Note: Issuance amounts are nominals

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

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (265)	4,041	58.2
Non Sovereigns	2,902	41.8
AAA (648)	1,219	17.6
AA (442)	614	8.8
A (654)	680	9.8
BBB (477)	390	5.6

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (783)	1,952	28.1
3 – 5 Yrs (663)	1,604	23.1
5 – 7 Yrs (446)	983	14.2
7 – 10 Yrs (372)	1,191	17.2
10+ Yrs (222)	1,212	17.5

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ June 11 & 09)		W't (%)	Dur'n (yrs)
Gilts (17)	272	186	91.5	16.1
< 5 Yrs (1)	22	33	7.4	2.1
5 – 15 Yrs (5)	104	63	35.0	8.0
> 15 Yrs (11)	146	90	49.0	23.9
Non Gilts (48)	25	20	8.5	17.5

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

Month End	US (%)	Euro (%)	Sterling (%)
Mar 11	6.86	7.57	8.28
Apr 11	6.72	7.20	8.14
May 11	6.79	7.06	8.26
June 11	7.06	7.66	8.68

