



Investment Update

July 2011

Investment Headlines & Comment

- Long-dated real yields on **Index-linked gilts** now just over 0.4%.
- 3.5% p.a. margins over German 5-year debt for **Spain** and **Italy**.
- **Principal** acquire a majority stake in **Origin** (Global Equity).

Feature Section

Earlier this year, in our February issue, we considered the implied trade-off between required default and recovery rates for High Yield (sub investment grade) corporate bonds to remain appealing in risk-reward terms. This month, we consider the actual default and recovery rates being experienced in the US market, and their historical profile. We have considered the Standard & Poor's transition rates survey in the past, for its investment grade components back in October 2002 (and across all credit ratings, briefly, in December 2008 as well), but we provide an update on that as well.

Figure 1a shows the annual default and recovery rates which have applied on US High Yield debt (default rate on the left, recovery rate on the right). The long run weighted averages (1982-2011) are the blobs on the right of the chart. Intuitively, you would expect the recovery rate to be lower at times when the default rate is high, and vice versa – comfortably, the data supports this with a strong negative correlation (-63%) between the two rates. However, there is also a high degree of variation in the rates over time – standard deviations of 3% for default rates and 10% for recovery rates, which may temper initial optimism about the current low default rates. Upgrades have exceeded downgrades each month for almost the last two years, and it is interesting to note that JP Morgan are currently predicting below-average default rates for the next three years. Figure 1b gives a comparison for this US default rate data, by using the historical averages for default rates across global High Yield over the same period, for the simple 1-year measure, and for the longer-term cumulative unannualised 5 year version (we can ignore longer periods, given that most High Yield funds focus on bonds with relatively short terms to maturity).

Figure 1a: US Default and Recovery Rates

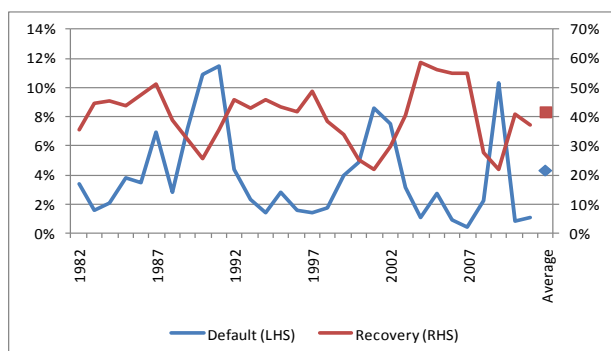


Figure 1b: Global Average Default Rates (%)

Time	1 year	5-year
Investment grade	0.13	1.21
AAA	0.00	0.38
AA	0.02	0.37
A	0.08	0.68
BBB	0.25	2.43
High Yield	4.36	17.48
BB	0.95	9.04
B	4.70	21.76
CCC/C	27.39	47.64
All ratings	1.61	6.79

Figure 1c: Global Credit Rating Transitions in 2010 (NB not long-term averages!)

Final rating	AAA	AA	A	BBB	BB	B	CCC	D	N.R.	
Starts as	AAA	73.6	25.0	-	1.4	-	-	-	-	
	AA	1.3	82.8	10.1	-	-	-	-	5.8	
	A	0.1	1.1	92.3	3.5	-	0.1	-	2.9	
	BBB	-	-	2.9	90.3	1.9	0.1	-	4.8	
	BB	-	-	-	5.6	81.7	3.9	0.1	0.6	8.1
	B	-	-	0.1	-	6.3	81.3	2.1	0.8	9.5
	CCC	-	-	-	-	0.5	29.6	33.6	22.3	14.1

Sources:

Figure 1a
JP Morgan

Figures 1b and 1c
Standard & Poor's

Other than down at the CCC “precipice” area (where you might bonds to either bounce back or go over the edge), you would expect the proportions retaining their initial rating to be high (these are the cells marked in bold on the first diagonal). However, Figure 1c shows that 2010 involved an unusual event, in the unusually high transition rate from AAA to AA (strictly 'AA+') - these were attributable to downgrades in the US, relating to Berkshire Hathaway, and to a lesser-but still significant--extent, the downgrades relating to Assured Guaranty. It is also interesting to note the extent to which some bonds ceased to be rated during the year (but these bonds still count in longer-term default statistics, if the period includes a time when they were rated). Another interesting angle, in case you are concerned that rating agencies are not keeping up to date versus what the market thinks of a bond, is to consider the proportion of debt which is currently trading at or below a specific proportion of its face value (“par”) – for example, 50% below par or 70% below par. Within the US market, only about 0.7% is at or below 50% of par, and only 1.7% is at or below 70% of par.



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 July 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	-2.2	-3.3	14.9	7.1	3.8	4.8	8.2
Overseas Equities	-4.0	-3.6	13.3	8.8	6.4	4.0	7.5
US Equities	-4.2	-3.2	14.3	9.8	5.3	1.4	9.7
Europe ex UK Equities	-6.9	-8.1	13.0	4.1	5.0	5.7	8.5
Japan Equities	1.3	5.2	8.0	4.4	-0.5	1.3	0.5
Pacific ex Japan Equities	-1.6	-1.8	16.4	16.0	15.1	13.8	9.7
Emerging Markets	-2.6	-2.8	12.4	12.6	14.3	15.6	9.6
UK Long-dated Gilts	4.8	4.1	9.2	7.9	5.3	5.7	8.9
UK Long-dated Corp. Bonds	3.8	2.1	8.0	8.8	4.4	5.9	-
UK Over 5 Yrs Index-Linked Gilts	3.8	6.1	15.9	7.1	7.3	7.2	8.1
High Yield (Global)	-1.3	1.4	8.6	20.8	12.4	7.8	-
Overseas Bonds	-0.1	4.2	3.8	14.5	11.1	6.5	7.4
Property *	0.7	2.1	9.1	0.2	-0.8	6.6	8.3
Cash	0.1	0.2	0.8	1.5	3.2	3.8	5.4
Commodities £-converted	0.2	-8.2	16.7	-12.2	-3.6	2.5	4.0
Hedge Funds original \$ basis *	-1.2	-0.9	11.5	3.1	4.8	6.7	11.6
Illustrative £-converted version *	1.3	-1.1	3.9	10.7	7.8	5.3	11.7
Euro relative to Sterling	-3.1	-1.6	5.3	3.6	5.1	3.6	-
US \$ relative to Sterling	-2.2	1.6	-4.6	6.5	2.6	-1.4	0.1
Japanese Yen relative to Sterling	2.4	6.8	7.1	19.1	11.0	3.5	3.1
Price Inflation (RPI) *	0.0	1.2	5.0	2.8	3.5	3.0	2.8
Price Inflation (CPI) *	-0.1	1.1	4.2	3.1	3.1	2.3	2.2
Price Inflation (RPIX) *	0.0	1.2	5.0	3.7	3.8	3.1	3.0
Earnings Inflation **	-0.1	-6.8	2.2	1.4	2.6	3.3	3.7
All Share Capital Growth	-2.3	-4.1	11.4	3.2	0.1	1.3	4.6
Net Dividend Growth	2.6	3.5	6.7	-6.7	1.1	3.7	-
Earnings Growth	13.6	14.4	72.3	5.6	5.4	8.6	-

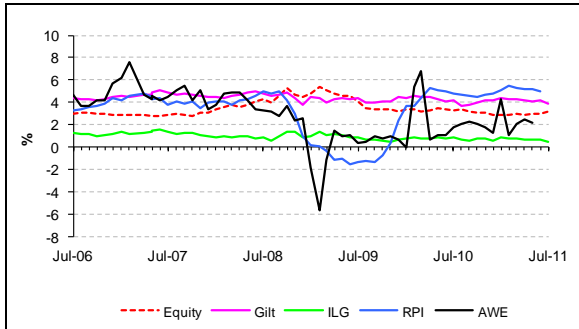
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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.

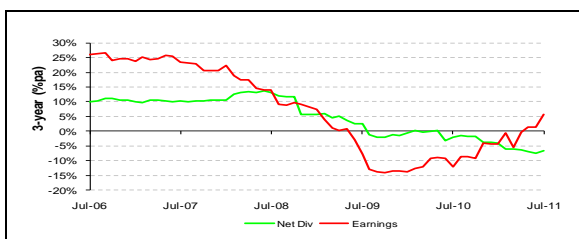
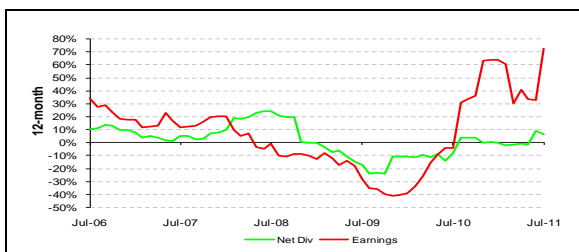


The gap gives expectations of just below 3.5% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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]

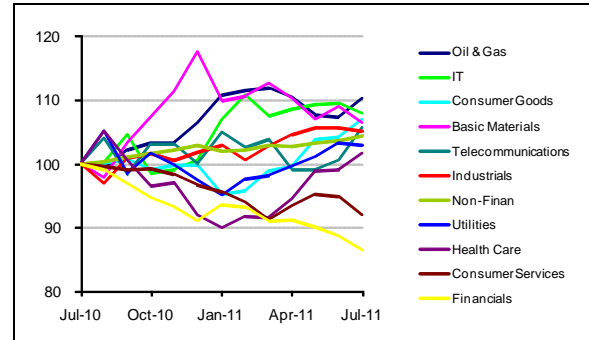
Figure 3: Dividend & Earnings Growth



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



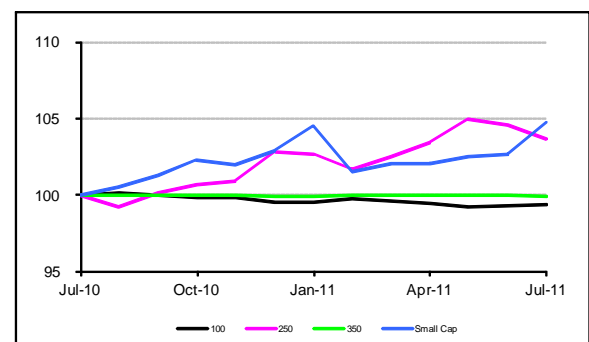
Note: Sector labels for relative lines are in end-value order

There was a rise this month in the rolling 12-month sector dispersion (up from 21% to 24%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	0.3	-3.6	26.6
Basic Materials	-4.5	-6.7	22.3
Industrials	-2.7	-2.8	20.9
Consumer Goods	0.4	3.7	22.9
Health Care	0.4	4.0	16.9
Consumer Services	-5.2	-4.9	5.7
Telecommunications	2.9	3.2	21.5
Utilities	-2.6	-0.1	18.3
Non-Finan	-1.5	-1.8	20.1
Financials	-4.8	-8.6	-0.8
IT	-3.7	-4.0	23.9
All Share	-2.2	-3.3	14.9

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

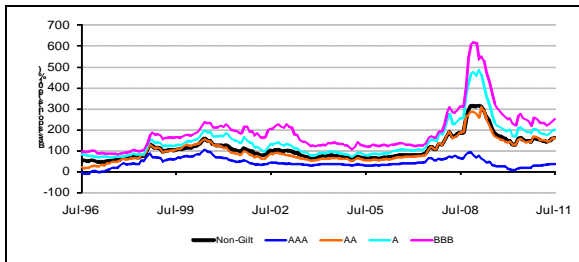


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
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
July 11	5.21	3.87	1.34

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

Category	Mkt Val (£bn @ July 11 & 09, 07)			Weight (%)
Gilts (33)	844	620	309	64.0
Non Gilts (1,023)	475	455	415	36.0
AAA (177)	128	145	151	9.7
AA (169)	74	65	63	5.6
A (386)	168	154	131	12.7
BBB (291)	106	89	68	8.0

Category	Mkt Val (£bn @ July 11, 09)		W't (%)	Dur'n (yrs)
Gilts (33)	844	620	64.0	9.3
< 5 Yrs (8)	232	163	17.6	3.0
5-15 Yrs (11)	301	226	22.9	7.1
> 15 Yrs (14)	311	231	23.6	16.0
Non Gilts (1,023)	475	455	36.0	7.6
< 5 Yrs (253)	117	153	8.8	2.7
5-15 Yrs (486)	216	179	16.4	6.8
> 15 Yrs (284)	142	124	10.8	12.9

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

£ Gilt Market “main” Issuance

- £5.11bn 2% 2016 (1.48x, 1.79%, prev June 11)
 - £3.57bn 3¾% 2021 (2.16x, 3.51%, June 11)
 - £2.18bn 4¼% 2040 (1.95x, 4.18%, May 11)
 - £1.00bn ILG 1¼% 2027 (1.64x, r.y 0.61%, Nov 10)
 - £4.00bn ILG ¾% 2034 (1.25x, r.y 0.64%, May 11)
- Note: Issuance amounts are nominals

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

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (267)	4,058	57.8
Non Sovereigns	2,967	42.2
AAA (660)	1,265	18.0
AA (449)	630	9.0
A (661)	690	9.8
BBB (469)	382	5.4

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (787)	1,973	28.1
3 – 5 Yrs (679)	1,613	23.0
5 – 7 Yrs (443)	1,004	14.3
7 – 10 Yrs (371)	1,191	17.0
10+ Yrs (226)	1,245	17.7

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ July 11 & 09)		W't (%)	Dur'n (yrs)
Gilts (17)	281	191	91.5	16.1
< 5 Yrs (1)	22	34	7.2	2.0
5 – 15 Yrs (5)	108	79	35.1	8.0
> 15 Yrs (11)	151	79	49.2	24.0
Non Gilts (48)	26	20	8.5	17.5

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

Month End	US (%)	Euro (%)	Sterling (%)
Apr 11	6.72	7.20	8.14
May 11	6.79	7.06	8.26
June 11	7.06	7.66	8.68
July 11	6.93	7.52	8.92

