JAGGER & ASSOCIATES

Investment Update
August 2011

Investment Headlines & Comment

- **Equity turmoil** this month – European markets down by 10%.
- **Corporate** and **High Yield** bond margins increased as well.
- **Gilt yields** and **ILG real yields** hit "modern era" lows this month.

Feature Section

A significant factor for the last two months' equity market turmoil was concern over major Eurozone countries' economies being more sensitive to developments in other smaller Eurozone members than had previously been expected (e.g. the extent of French banks' exposure to Greek debt). This may, however, have had rather more effect on domestic equity markets' returns than on the pan-European indices' returns, as these indices tend to have larger capitalization requirements (e.g. within the FT All-World index, only 115 UK stocks are counted). In turn, those larger cap stocks may have a wider range of non-domestic exposure, thus reducing their sensitivity to country-specific concerns. This is arguably supported by the correlations over the last 10 years between the major European markets (and the UK) being well over 80%, indeed in some cases over 90%.

We looked at European equities in the April 2007 *Update*, but the focus in this item is different – the mix of Eurozone and non-Eurozone equities within the Europe ex UK market, and whether their returns have diverged significantly or not. The Eurozone accounts for almost two thirds of the market, both by number of stocks and by market capitalization, and the P/E ratio is about 8.5x, versus 9.2x for Europe ex UK, which suggests Eurozone equities are thought to be riskier. However, there is a significant dispersion of P/E ratios by country – geographically, higher P/Es for Nordic than for Eastern Europe, but even the Nordic P/Es only average 10.4x.

Figure 1a summarises the profile, with E denoting Eurozone membership, and the figure in brackets being the number of stocks involved for the country within the FT All-World index. The main countries and weights are highlighted in the labeling, with France and Germany accounting for almost 40%. Most of the non-Eurozone element is accounted for by Switzerland and Sweden in the final quadrant of the chart, and Norway. Figure 1b shows the cumulative Sterling returns on European equities since September 2008, which is when the first divergence in underlying bond yields started to appear for Euro-denominated government bonds. The labels are listed in the order of the end values.

Figure 1a: Europe ex UK – Equity Market Cap profile

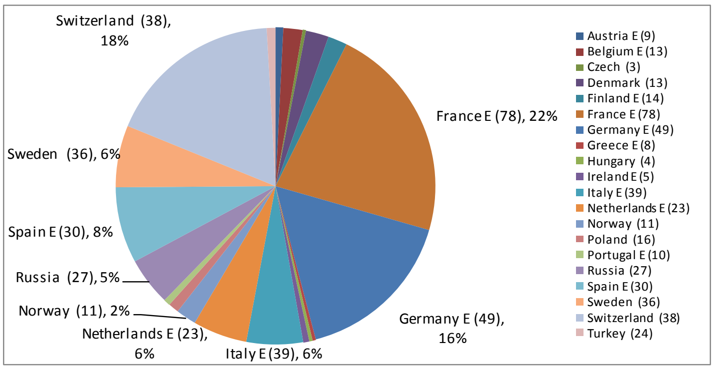
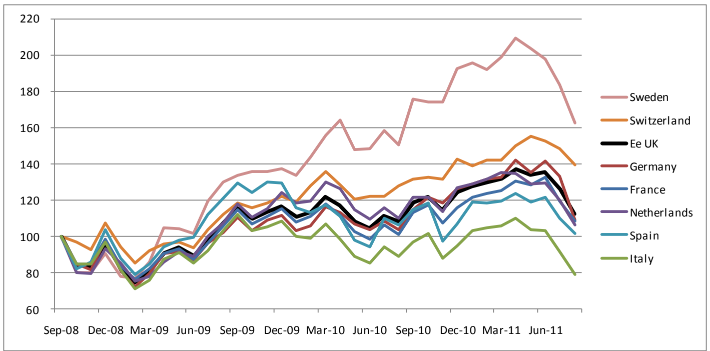


Figure 1b: Returns since September 2008



Sources: FTSE, Jagger & Associates
*Note: * Our thanks go to Baillie Gifford for helping on this data point.*

Over the period since September 2008, Europe ex UK Equities have returned 12% (unannualised) which compares with 25% for the All Share index. However, Figure 1b shows a huge dispersion, with the Eurozone countries underperforming (including Germany) – the Eurobloc cumulative return has been 2% through average losses of about 10% in local currency terms (although Italy was far worse than the others) being offset by 12% from the Euro *strengthening* against Sterling over the period, hence. (Yes, even against the background of all this Euro worry, it has appreciated against Sterling.)

So, what has led to such strong Sterling results for the non-Eurozone markets shown? For Switzerland, the entire return is currency-related, as the Swiss Franc has risen against Sterling by about 50% over the period, albeit reduced by a small loss in local terms.

However, for Sweden, whilst about 20% relates to appreciation of the Swedish Krona, a further 35% relates to local market gains, well ahead of the All-Share. The dominant Swedish sectors (*) have been their banks (they had few bad property debts, relative to those faced by other European banks) and their industrial companies (who tend to have strong exports to emerging markets).

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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 August 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	-6.9	-9.3	7.3	2.9	2.1	4.3	7.7
Overseas Equities	-6.5	-9.2	7.8	4.2	4.8	4.1	7.2
US Equities	-4.7	-8.0	**11.8**	4.5	4.2	1.7	8.9
Europe ex UK Equities	**-10.9**	**-15.9**	3.6	**-0.9**	2.2	5.0	8.1
Japan Equities	-7.2	-2.1	0.7	0.3	**-1.9**	**1.0**	**0.4**
Pacific ex Japan Equities	-7.8	-8.7	6.7	12.2	**12.9**	13.2	**9.4**
Emerging Markets	-8.2	-9.6	3.3	9.4	12.2	**14.9**	9.3
UK Long-dated Gilts	2.4	5.1	3.2	7.9	5.5	5.7	8.9
UK Long-dated Corp. Bonds	-0.5	0.9	**-0.1**	7.9	4.0	5.6	-
UK Over 5 Yrs Index-Linked Gilts	-0.6	3.8	9.2	5.3	6.8	6.9	8.0
High Yield (Global)	-3.6	-3.5	2.8	**16.3**	11.6	7.5	-
Overseas Bonds	**3.1**	**6.0**	2.9	13.1	12.0	6.6	7.4
Property *	0.6	2.0	8.9	0.8	-0.9	6.6	8.3
Cash	0.1	0.2	0.8	1.4	3.2	3.8	5.3
Commodities £-converted	-1.1	-3.7	20.0	-12.7	-2.0	2.4	3.8
Hedge Funds original $ basis *	0.3	-2.1	10.1	4.0	4.9	6.8	11.5
Illustrative £-converted version *	-1.9	-0.4	5.0	10.7	7.7	5.3	11.6
Euro relative to Sterling	1.0	1.2	6.9	3.1	5.6	3.5	-
US $ relative to Sterling	0.8	1.1	-5.6	3.9	3.2	-1.1	0.2
Japanese Yen relative to Sterling	1.8	7.4	3.7	16.7	12.4	3.3	3.1
Price Inflation (RPI) *	-0.2	0.1	5.0	2.7	3.4	3.1	2.8
Price Inflation (CPI) *	0.0	0.1	4.5	3.1	3.1	2.4	2.2
Price Inflation (RPIX) *	-0.3	0.1	5.0	3.7	3.8	3.2	2.9
Earnings Inflation **	1.5	-9.6	2.9	1.7	2.5	3.3	3.8
All Share Capital Growth	-7.5	-10.3	3.8	-0.8	-1.4	0.8	4.0
Net Dividend Growth	2.0	4.5	6.6	-5.6	1.3	3.7	-
Earnings Growth	**3.1**	17.2	52.0	8.8	5.5	9.2	-

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.*

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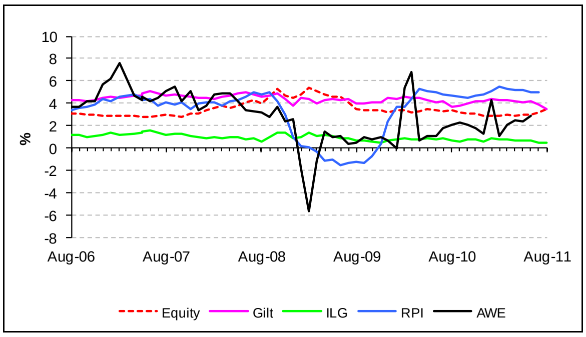
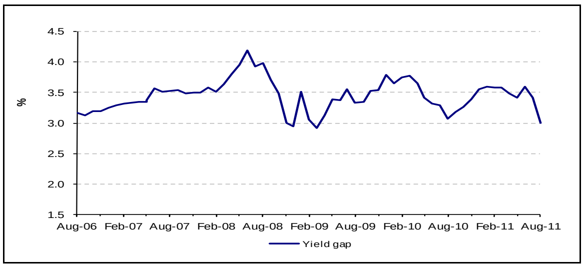
Yields and Yield Gaps

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.

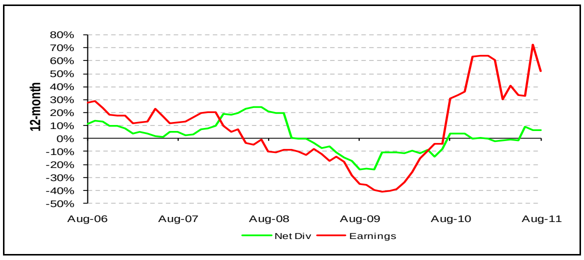


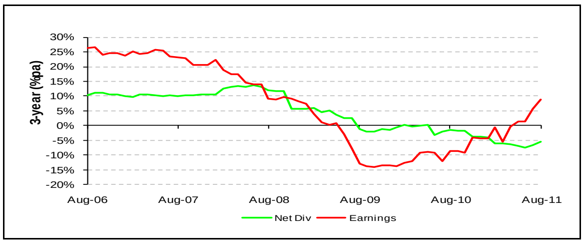
The gap gives expectations of now only 3% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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

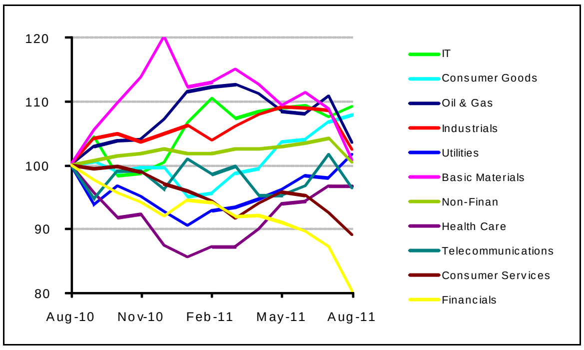




Sources for charts on this page:
Financial Times, Office for National Statistics, J&A

UK Equity Sector Returns

Figure 4a: Sectors relative to All Share



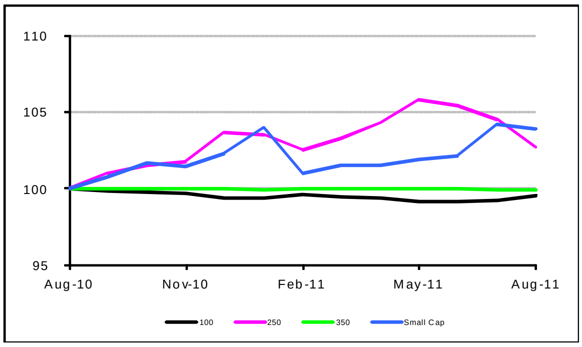
Note: Sector labels for relative lines are in end-value order

There was a marked rise this month in the rolling 12-month sector dispersion (up from 24% to 29%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	-8.8	-9.2	16.5
Basic Materials	-9.6	-12.4	13.3
Industrials	-7.9	-10.7	15.2
Consumer Goods	-1.3	-1.0	21.4
Health Care	-2.3	-2.2	8.8
Consumer Services	-6.0	-11.7	0.0
Telecommunications	-7.5	-3.8	8.4
Utilities	1.3	0.5	14.3
Non-Finan	-6.0	-7.3	12.8
Financials	-10.2	-16.2	-9.8
IT	-0.9	-4.8	22.8
All Share	-2.3	-4.9	12.5

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.

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Bond market information

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

Figure 5: £ Non-Gilt Credit Margins

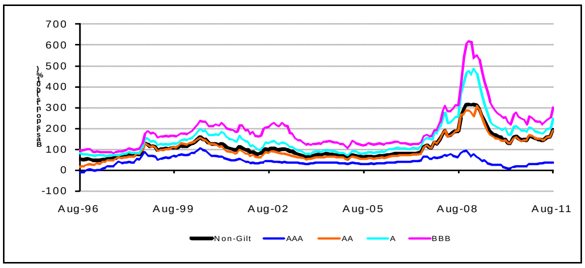

Table 2a: Over 15 Yr <u>Corporate</u> Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
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
Aug 11	**5.30**	**3.68**	**1.62**

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

Category	Mkt Val (£bn @ Aug 11 & 09, 07)			Weight (%)
Gilts (33)	874	650	316	65.1
Non Gilts (1,022)	469	469	420	34.9
AAA (170)	126	149	156	9.4
AA (178)	78	69	63	5.8
A (386)	163	156	130	12.1
BBB (288)	103	92	68	7.7

Category	Mkt Val (£bn @ Aug 11, 09)		W't (%)	Dur'n (yrs)
Gilts (33)	874	650	65.1	9.4
< 5 Yrs (8)	238	165	17.7	3.0
5–15 Yrs (11)	310	23	23.1	7.2
> 15 Yrs (14)	326	250	24.3	16.2
Non Gilts (1,022)	469	469	34.9	7.6
< 5 Yrs (259)	118	157	8.8	2.7
5–15 Yrs (482)	211	183	15.7	6.8
> 15 Yrs (281)	141	133	10.5	12.8

£ Gilt Market "main" Issuance

- £4.73bn 1¾% 2017 (1.35x, 1.51%, new)
- £2.00bn 4½% 2034 (2.23x, 3.96%, prev Nov 10)
- £1.07bn ILG 1 7/8% 2022 (2.05x, r.y **-0.07%**, May 11)
- £0.91bn ILG 5/8% 2042 (1.85x, r.y 0.53%, Mar 11)

Note: Issuance amounts are nominals. This is the first month an ILG has been issued on a negative real yield.

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

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (248)	4,048	57.6
Non Sovereigns	2,977	42.4
AAA (662)	1,290	18.4
AA (454)	635	9.1
A (651)	672	9.6
BBB (475)	379	5.4

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (805)	1,996	28.4
3 – 5 Yrs (664)	1,583	22.5
5 – 7 Yrs (430)	991	14.1
7 – 10 Yrs (375)	1,207	17.2
10+ Yrs (216)	1,247	17.8

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Aug 11 & 09)		W't (%)	Dur'n (yrs)
Gilts (17)	286	199	91.7	16.0
< 5 Yrs (2)	49	34	15.6	3.4
5 – 15 Yrs (4)	82	81	26.2	9.0
> 15 Yrs (11)	155	84	49.9	23.6
Non Gilts (48)	26	20	8.3	17.3

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
Aug 11	**7.82**	**9.25**	**10.26**

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