



Investment Update June 2013

Investment Headlines & Comment

- A volatile month for **equities**, and a bad month for most **bonds** as the USA's QE taps may turn off.
- A new **2068 gilt**. However, three gilt post-auction options were not used, so is demand tapering off?
- UBS's **Triton** Property fund gets refinanced by three pension funds, to avoid forced sales of holdings.

Feature Section

This month we revisit the current levels of correlation between UK and Overseas Equities (last considered in August 2007), and ask what similarity or otherwise exists at the sector level for the two asset classes. Reducing UK exposure in favour of Overseas is now common, but is it justifiable?

Figure 1a shows the history of correlation levels between UK Equities and other regions, based on sterling (unhedged) returns over successive rolling 5-year periods (to be fair, this is an arbitrary period, but it seems to be one in common use). The chart shows that, during the 1990s and early 2000s, market correlations had been rising pretty steadily in most cases. After the "credit crunch" period, the Europe ex UK and overall World ex UK indices have remained at just over 90% correlated with the UK. Interestingly, the US and Pacific ex Japan markets seem to have stabilised at a slightly lower level, although still over 80%. However, in all cases the benefit from diversification has generally reduced relative to the benefit it could have provided in the early 1990s – not least because where a company's shares are listed is now less of an indicator of where its earnings arise.

Figure 1a: Correlations with the UK

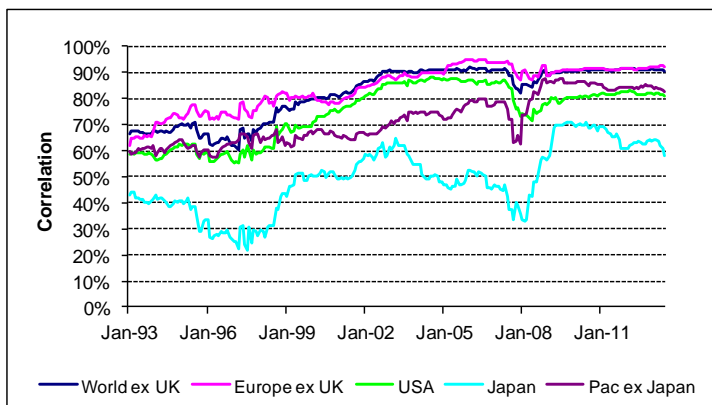
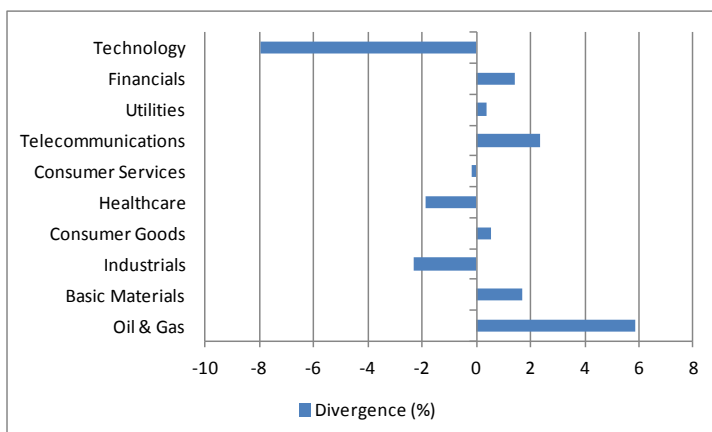


Figure 1b: Sector divergences



Sources: FTSE, Jagger & Associates

We suspect the answer to that is "no", particularly when you consider the "tech bubble" experience of the late 1990s, and if you take more comfort in the UK's regulation system. Also, the overseas regions have had markedly higher volatility than the UK (even if the overall World ex UK's volatility is only slightly greater than the UK's). However, for the optimists out there (**Ed.**: which rules out most actuaries), and for the risk-takers, then that answer could be modified to "perhaps".

With c.2,900 stocks, the World UK index is much more diversified than the UK's All Share index (in the UK, c.600 stocks, but only c.120 count for the World index). This would normally run counter to the high level of correlation between the markets as shown in Figure 1a, but it acts as further evidence of the likely globalization within "UK" stocks, in terms of where the companies actually generate their earnings. Some might claim that the US dominance in the World ex UK index distorts things, but if you consider a 1/3:1/3:1/3 mix of Europe, US and Far East, you still get a pretty stable 91% correlation with the UK.

So, how similar are the sector distributions for the UK and World ex UK indices? Figure 1b shows most of the divergences at the broad sector levels are small, with the main position being that the UK has a much lower Technology weighting and a much higher Oil & Gas weighting. This has applied since the current sector classifications came in during early 2006.

If you were to break down within individual sectors, there might be some further quirks. For example, within Industrials, the UK is overweight in Support Services, and underweight in General Industrials, but the positions are much much smaller than the Tech / Oil split shown in Figure 1b. So, does that sector split warrant a move away from UK-dominant equity mandates for investors?



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 2013

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	-5.0	-1.7	17.9	12.8	6.7	9.0	7.8
Overseas Equities	-2.7	0.1	21.9	12.4	9.0	9.3	7.1
US Equities	-1.4	3.0	24.9	17.9	13.1	8.5	8.7
Europe ex UK Equities	-4.8	0.4	26.7	9.4	3.7	9.5	8.6
Japan Equities	1.7	4.5	26.3	8.2	5.5	7.1	0.2
Pacific ex Japan Equities	-6.0	-7.4	13.4	7.1	9.6	14.6	7.6
Emerging Markets	-6.4	-7.9	6.7	3.2	5.5	15.0	7.7
UK Long-dated Gilts	-3.7	-5.9	-4.6	7.8	8.5	5.9	8.0
UK Long-dated Corp. Bonds	-5.5	-4.3	4.4	7.9	8.8	5.6	-
UK Over 5 Yrs Index-Linked Gilts	-5.2	-7.4	2.7	9.6	7.2	7.2	7.5
High Yield (Global)	-2.8	-1.2	15.1	10.6	16.7	10.1	-
Overseas Bonds	-0.6	-2.9	-1.7	2.1	9.4	5.8	5.6
Property *	0.6	1.5	3.4	6.1	1.4	5.6	8.5
Cash	0.0	0.1	0.6	0.8	1.3	3.2	4.5
Commodities £-converted	0.2	-5.9	5.5	4.2	-10.5	2.3	3.4
Hedge Funds original \$ basis *	0.6	2.3	10.1	5.1	2.5	6.5	9.5
Illustrative £-converted version *	3.3	2.4	11.7	3.6	8.1	7.3	9.7
Euro relative to Sterling	0.3	1.3	5.9	1.5	1.6	2.1	-
US \$ relative to Sterling	-0.1	0.1	3.4	-0.5	5.6	0.8	-0.1
Japanese Yen relative to Sterling	1.6	-5.2	-17.0	-4.2	7.0	2.8	0.3
Sterling trade weighted	0.2	0.3	-3.2	-0.6	-3.0	-1.9	-0.3
Price Inflation (RPI) *	0.2	1.0	3.1	3.8	3.1	3.3	2.9
Price Inflation (CPI) *	0.2	0.7	2.7	3.3	3.1	2.7	2.1
Price Inflation (RPIX) *	0.2	0.9	3.1	3.8	3.6	3.3	2.9
Earnings Inflation **	-5.9	2.1	3.7	2.9	2.1	3.2	3.6
All Share Capital Growth	-5.3	-2.7	13.8	9.0	2.9	5.3	4.2
Net Dividend Growth	0.4	2.5	8.8	11.0	-0.1	5.6	-
Earnings Growth	-1.0	9.6	-9.0	7.9	-0.3	8.0	6.8

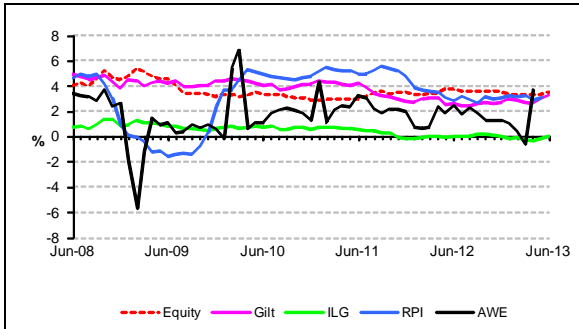
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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.

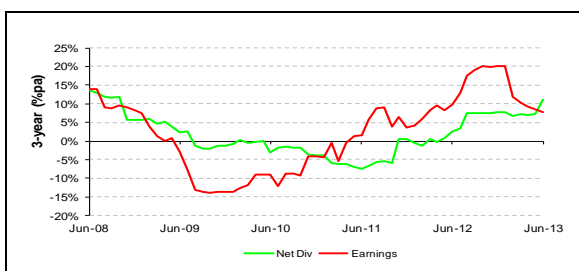
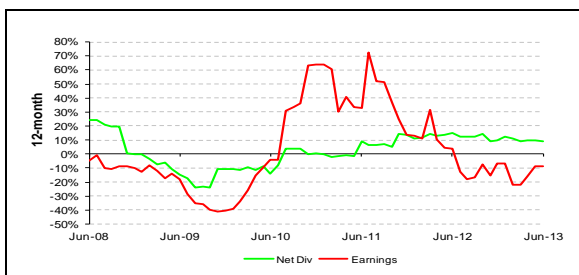


The gap gives a current expectation of now well over 3% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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]

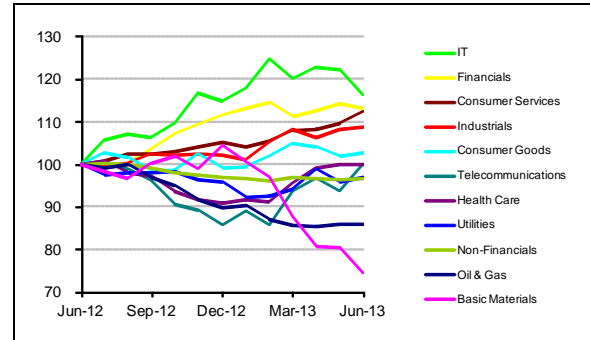
Figure 3: Dividend & Earnings Growth



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



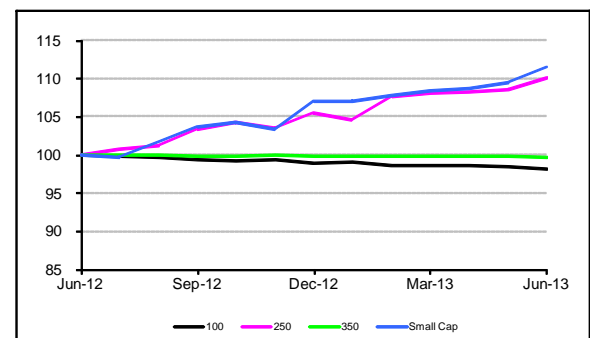
Note: Sector labels for relative lines are in end-value order

There was a slight rise this month in the rolling 12-month sector dispersion (from 40% to 42%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	-5.0	-1.4	1.3
Basic Materials	-12.0	-16.6	-12.3
Industrials	-4.5	-1.2	28.3
Consumer Goods	-4.3	-3.9	21.1
Health Care	-4.9	2.9	18.0
Consumer Services	-2.5	2.3	32.6
Telecommunications	1.7	5.2	18.1
Utilities	-3.9	1.1	14.2
Non-Financials	-4.7	-2.1	13.9
Financials	-5.8	0.0	33.6
IT	-9.7	-4.9	37.0
All Share	-5.0	-1.7	17.9

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

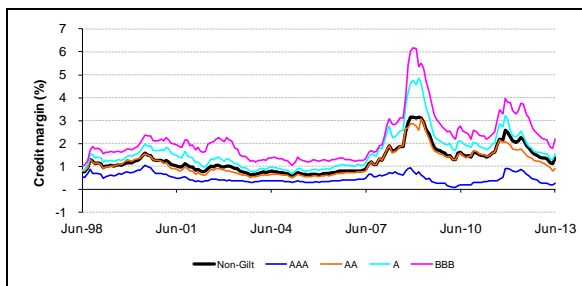


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
Jan 13	4.26	2.99	1.27
Feb 13	4.18	2.94	1.24
Mar 13	4.01	2.76	1.25
Apr 13	3.75	2.63	1.12
May 13	4.02	2.96	1.06
Jun 13	4.47	3.30	1.17

Tables 2b, 2c: £ Market Size (£bn) and Maturity

Category	Mkt Val @ Jun 13 & 10, 07			Weight (%)
	Jun 13	Jun 10	Jun 07	
Gilts (36)	1,066	760	299	67.5
Non Gilts (1,025)	514	469	410	32.5
AAA (135)	105	141	147	6.7
AA (159)	82	75	65	5.2
A (363)	170	164	128	10.8
BBB (368)	157	89	68	9.9

Category	Mkt Val @ Jun 13, & 10		W't (%)	Dur'n (yrs)
Gilts (36)	1,066	760	67.5	9.3
< 5 Yrs (10)	313	211	19.8	2.7
5-15 Yrs (11)	363	292	23.0	7.1
> 15 Yrs (15)	390	257	24.7	16.7
Non Gilts (1,025)	514	469	32.5	7.9
< 5 Yrs (294)	146	134	9.3	2.8
5-15 Yrs (439)	205	204	13.0	7.2
> 15 Yrs (292)	163	132	10.3	13.2

£ Gilt Market “main” Issuance

- o £4.75bn 1¼% 2018 (1.33x, 1.42%, May 13)
 - o £3.75bn 2¼% 2023 (1.52x, 2.37%, new)
 - o £2.25bn 4¼% 2032 (1.45x, 3.00%, Oct 12)
 - o £5.00bn 3½% **2068** (2.56x, 3.65%, new)
 - o £1.68bn ILG 1/8% 2024 (1.95x, r.y -0.76%, Apr 13)
- Note: Issuance amounts are nominals.

Tables 2d, 2e: € Market Size and Maturity (Jun 13)

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (276)	4,767	59.6
Non Sovereigns	3,238	40.4
AAA (536)	1,045	13.1
AA (380)	626	7.8
A (762)	849	10.6
BBB (701)	717	8.9

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (798)	2,181	27.2
3 – 5 Yrs (739)	1,786	22.3
5 – 7 Yrs (431)	1,164	14.5
7 – 10 Yrs (468)	1,460	18.2
10+ Yrs (219)	1,414	17.7

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Jun 13 & 10)		W't (%)	Dur'n (yrs)
Gilts (21)	354	235	92.1	18.7
< 5 Yrs (2)	44	36	11.5	3.5
5 – 15 Yrs (5)	98	93	25.5	9.5
> 15 Yrs (14)	212	105	55.1	26.1
Non Gilts (43)	30	24	7.9	16.9

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

Month End	US (%)	Euro (%)	Sterling (%)
Jan 13	5.76	5.27	6.30
Feb 13	5.76	5.07	6.33
Mar 13	5.69	5.11	6.24
Apr 13	5.43	4.66	5.89
May 13	5.64	4.73	6.12
Jun 13	6.26	5.36	6.64

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

