



Investment Update September 2013

Investment Headlines & Comment

- **Fidelity** are pushing for long-term share incentives to mature after five, rather than three, years.
- A new ultra-long **Index Linked Gilt** maturing in 2068 has been launched on a real yield of 0.14%.
- **ONS data** shows the **UK Equity market** over 50% foreign-owned. Any governance implications?

Feature Section

This month we turn to Gross Domestic Product (GDP), and consider the inflation measure used to adjust GDP from different years to enable a comparison “in real terms”. This adjustment is made using so-called ‘deflators’ (a type of inflation index), either by dividing back to an earlier year (hence the term “deflator”), or scaling up earlier years to the current year. There is a neat formula for summarizing $GDP = C + I + G + X - M$, or for those who don’t like algebra:

$$\begin{array}{rclclcl}
 \text{GDP} & = & \text{private consumption} & + & \text{gross investment} & + & \text{government spending} & + & (\text{exports} - \text{imports}) \\
 1,564 & = & 1,030 & + & 231 & + & 341 & + & 494 - 529
 \end{array}$$

Notes: “gross investment” is the usual abbreviation of “gross private domestic investment”
Government spending here relates just to departmental spending, and excludes pensions and welfare, as otherwise there would be double counting (in the private consumption area).

The figures shown are the latest calendar year’s values (in £bn) from the ONS ([Table C1](#)), and there is a small rounding error term as well. However, the ‘deflator’ adjustment used to relate these figures to other years “in real terms” is not a ‘standard’ inflation index. In the words of HM Treasury:

“The Consumer Prices Index (CPI) and the Retail Prices Index (RPI) are the two main measures of consumer inflation in the UK. The Producer Price Index (PPI) measures the price changes of goods bought and sold by UK manufacturers. The Services Producer Price Index (SPPI) measures the price changes of services provided by UK businesses to other businesses and government. The GDP deflator is a much broader price index than the CPI, RPI (which only measure consumer prices), or PPI as it reflects the prices of all domestically produced goods and services in the economy. Hence, the GDP deflator also includes the prices of investment goods, government services and exports, and excludes the price of UK imports. The wider coverage of the GDP deflator makes it more appropriate for deflating public expenditure series.”

Now, some of the time, this choice of index does not make much difference – see Figures 1a and 1b below, with Figure 1a showing the indices (scaled to converge to 100 at the end), and Figure 1b showing the rolling 10-year correlations. Having pretty much matched each other over the first 30 years, RPI has cumulatively exceeded the GDP deflator by 20% over the last 25 years (hence not a good fit), although instead GDP and CPI have been extremely close over this latter 25 year period. Curiously, however, the deflator’s correlation with *both* RPI and CPI has broken down over the last 15 years. It’s not obvious why this might be, although it could be due to a rise in government spending changing the balance of the deflator, or perhaps that population-related items allowed for in the GDP deflator take time to work through to the RPI and CPI indices. (**Ed.:** If anyone has an interesting and intelligible explanation, we’d happily run a second article!)

Figure 1a: Index comparisons

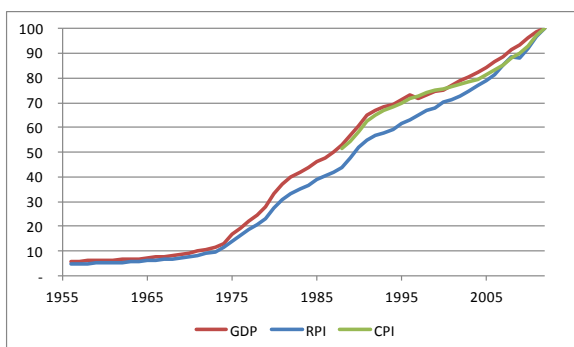
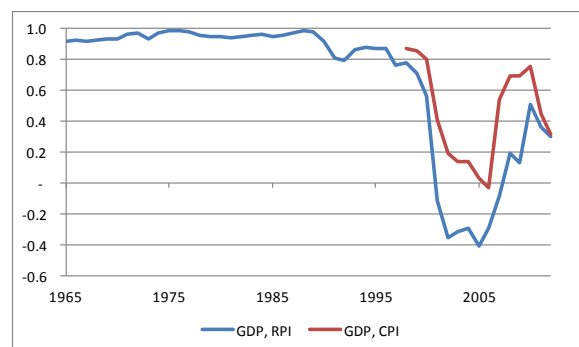


Figure 1b: Rolling 10-year correlations





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 September 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	1.1	5.6	18.9	10.1	10.7	9.2	7.8
Overseas Equities	0.5	0.8	18.2	9.7	10.5	8.9	6.9
US Equities	-1.3	-1.0	19.7	15.4	12.3	8.2	8.5
Europe ex UK Equities	3.3	6.9	27.1	7.3	7.9	9.8	8.4
Japan Equities	3.5	0.1	31.2	8.2	7.3	5.0	0.0
Pacific ex Japan Equities	1.3	0.6	6.9	3.2	13.2	13.2	7.0
Emerging Markets	1.8	-0.8	1.1	-0.9	9.6	13.5	7.2
UK Long-dated Gilts	1.5	1.3	-4.4	6.3	8.0	6.2	7.5
UK Long-dated Corp. Bonds	1.5	3.2	1.3	6.7	9.9	5.9	-
UK Over 5 Yrs Index-Linked Gilts	0.6	0.5	6.6	8.3	7.6	7.3	7.2
High Yield (Global)	-2.8	-3.2	8.4	8.2	16.1	9.5	-
Overseas Bonds	-3.0	-4.2	-5.5	-0.2	6.6	5.2	5.1
Property *	0.9	2.5	5.5	6.0	2.7	5.6	8.5
Cash	0.0	0.1	0.5	0.8	1.0	3.1	4.5
Commodities £-converted	-7.7	-1.8	-4.4	2.7	-6.7	2.1	3.3
Hedge Funds original \$ basis *	-0.7	-0.8	6.8	4.5	3.4	5.9	9.0
Illustrative £-converted version *	-2.7	-2.8	9.6	4.3	6.9	6.1	8.8
Euro relative to Sterling	-1.9	-2.4	4.9	-1.2	1.2	1.8	-
US \$ relative to Sterling	-4.4	-6.3	-0.2	-0.9	1.9	0.3	-0.4
Japanese Yen relative to Sterling	-4.5	-5.2	-21.0	-6.1	3.6	1.6	0.0
Sterling trade weighted	2.7	4.1	-0.8	1.6	-1.6	-1.4	-0.1
Price Inflation (RPI) *	0.5	0.4	3.3	3.8	2.9	3.3	2.9
Price Inflation (CPI) *	0.5	0.2	2.7	3.2	2.9	2.7	2.2
Price Inflation (RPIX) *	0.5	0.4	3.3	3.8	3.5	3.3	2.9
Earnings Inflation **	-2.2	-3.5	0.7	1.8	1.5	2.8	3.4
All Share Capital Growth	1.0	4.7	14.8	6.3	6.8	5.4	4.2
Net Dividend Growth	-0.8	1.1	7.6	8.9	0.5	5.6	-
Earnings Growth	-0.4	-10.9	-14.0	2.8	-1.5	6.6	6.0

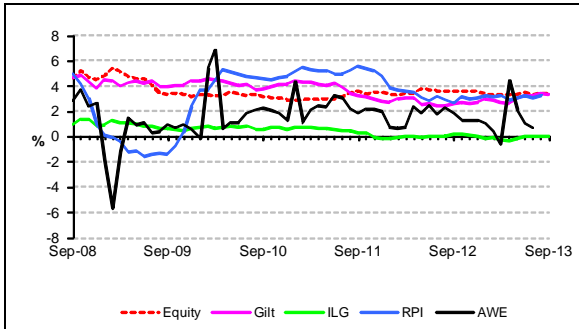
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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.

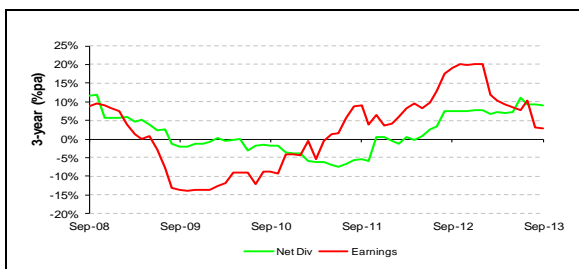
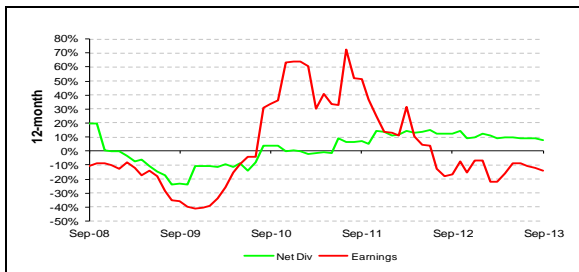


The gap gives a current expectation now clearly over 3% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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]

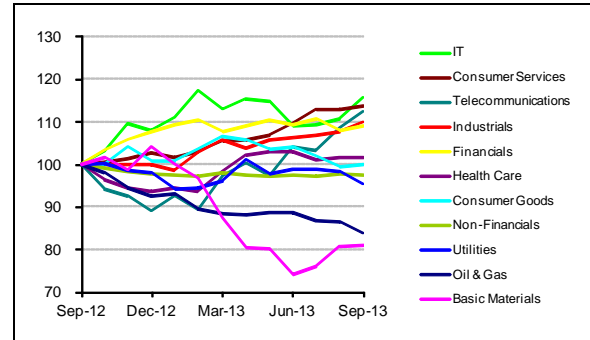
Figure 3: Dividend & Earnings Growth



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



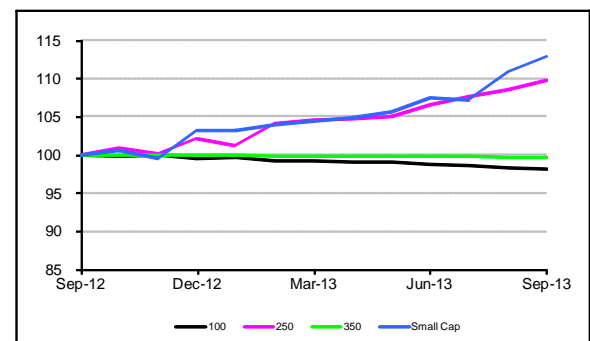
Note: Sector labels for relative lines are in end-value order

There was a rise this month in the rolling 12-month sector dispersion (from 29% to 35%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	-2.3	-0.3	-0.5
Basic Materials	1.7	15.5	-3.5
Industrials	3.1	9.2	30.6
Consumer Goods	1.4	1.2	18.8
Health Care	1.3	4.4	21.0
Consumer Services	1.8	9.5	35.2
Telecommunications	4.7	14.1	33.7
Utilities	-2.2	1.7	13.3
Non-Financials	0.8	5.7	16.1
Financials	2.0	5.2	29.6
IT	5.8	11.9	37.6
All Share	1.1	5.6	18.9

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Mid Cap and Small Cap both rose in relative terms this month.

FRS17 volatility indicator

Now discontinued, but available on request.



Bond market information

Figure 5: £ Non-Gilt Credit Margins

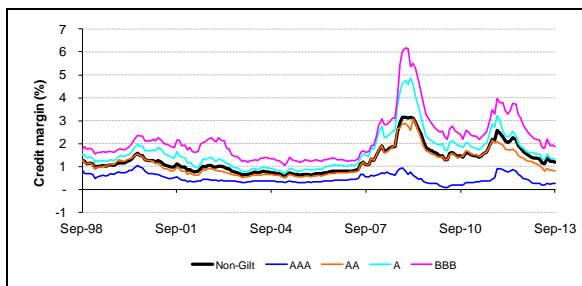


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
Apr '13	3.75	2.63	1.12
May '13	4.02	2.96	1.06
Jun '13	4.47	3.30	1.17
Jul '13	4.29	3.27	1.02
Aug '13	4.35	3.42	0.93
Sep '13	4.27	3.34	0.93

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

Category	Mkt Val @ Sep 13 & 10, 07			Weight (%)
	Sep 13	10, 07	Weight (%)	
Gilts (38)	1,090	816	313	67.7
Non Gilts (1,023)	520	489	421	32.3
AAA (135)	106	147	157	6.6
AA (163)	84	75	63	5.2
A (354)	167	171	130	10.4
BBB (371)	163	96	68	10.1

Category	Mkt Val @ Sep 13, & 10		W't (%)	Dur'n (yrs)
Gilts (38)	1,090	816	67.7	9.3
< 5 Yrs (11)	333	217	20.7	2.7
5-15 Yrs (11)	351	313	21.8	7.1
> 15 Yrs (16)	406	286	25.2	16.7
Non Gilts (1,023)	520	489	32.3	7.8
< 5 Yrs (299)	149	137	9.2	2.7
5-15 Yrs (439)	209	212	13.0	7.2
> 15 Yrs (285)	162	140	10.1	13.3

£ Gilt Market “main” Issuance

- o £5.08bn 1¼% 2018 (1.59x, 1.65%, Aug 13)
 - o £4.12bn 2¼% 2023 (1.59x, 2.98%, Jul 13)
 - o £3.02bn 3¼% 2044 (1.46x, 3.74%, Jul 13)
 - o £1.63bn ILG 1/8% 2024 (1.87x, r.y -0.16%, Jun 13)
 - o £5.00bn ILG 1/8% 2068 (2.16x, r.y 0.14%, new)
- Note: Issuance amounts are nominals.

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

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (276)	4,759	59.5
Non Sovereigns	3,242	40.5
AAA (539)	1,043	13.0
AA (384)	642	8.0
A (736)	817	10.2
BBB (725)	741	9.3

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (798)	2,171	27.1
3 – 5 Yrs (711)	1,776	22.2
5 – 7 Yrs (447)	1,155	14.4
7 – 10 Yrs (480)	1,491	18.6
10+ Yrs (224)	1,407	17.6

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Sep 13 & 10)		W't (%)	Dur'n (yrs)
Gilts (23)	373	239	92.3	19.0
< 5 Yrs (2)	44	21	11.0	3.2
5 – 15 Yrs (6)	103	97	25.6	9.3
> 15 Yrs (15)	225	121	55.7	26.5
Non Gilts (43)	31	25	7.7	17.0

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

Month End	US (%)	Euro (%)	Sterling (%)
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
Jul 13	5.96	5.06	6.22
Aug 13	6.16	5.09	6.32
Sep 13	6.06	5.04	6.19

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

