



Investment Update October 2014

Investment Headlines & Comment

- More downward pressure on gilt yields - £4bn of a **2068 gilt** issued on a yield *below 3%* and long-dated real yields hit new negatives.
- The UK has issued £300m of a 3-year **Chinese bond** – the proceeds will be used to finance the UK's reserves, not domestic expenditure.
- **FTSE DC benchmark indices** have been launched. A range of private client indices with Lifestyle by expected retirement date.

Feature Section

This month we welcome a guest contributor, Raj Sharma of Pinsent Masons, with news of what a Dutch housing association did that could have applications for UK Trustees (either of pension schemes or potentially of endowment funds as well) on using derivatives.

Why do trustees need to be careful when using derivatives? We've had a timely recent reminder that trustees need to be careful about their investment powers when using derivatives. The issue, briefly, is that if trustees are using derivatives, particularly non-exchange traded derivatives such as swaps and forwards, they need to ensure that their investment powers are wide enough to permit this. This has always been an important point for investors, and Hammersmith & Fulham council famously fell foul of it in the early 1990s. But [a recent court decision](#) involving Credit Suisse has highlighted the need for extreme care.

What happened in the Credit Suisse case? The case involved Credit Suisse and a Dutch housing association, Stichting Vestia Groep (SVG) and even though the transaction appears to have been in the Netherlands, it was heard in the London High Court. SVG bought eleven interest rate hedges from Credit Suisse under international standard documentation, in Euros and by reference (for the floating leg) to Euribor. Interest rates moved against SVG meaning that it was exposed to enormous costs on the hedges. SVG could not provide security for its mounting liabilities, so Credit Suisse decided to terminate the contracts and enforce the £65m owed by SVG. In response, SVG argued that it had acted outside its legal powers when it entered into the contracts. This would mean that the contracts were invalid.

The judge agreed that SVG had indeed acted outside of its powers in entering into some of the contracts. But he ruled that Credit Suisse was entitled to enforce all of the invalid contracts, because the ISDA master agreement between Credit Suisse and SVG included representations from SVG that it was legally entitled to enter into the contracts. So SVG is left with the worst of both worlds: it acted outside its powers, yet is faced with paying the full £65m debt.

What is the risk for trustees? Pension trustees who have a liability driven investment (LDI) strategy, or who use derivatives in more limited ways, need to look at whether they face a risk, and what investment powers are set out in their Trust Deed. If a scheme's LDI strategy uses pooled funds then there is generally less danger, because the trustees will not hold derivatives in their own name – although the terms of the pooled fund documents and the way in which the investments are structured will still need to be checked. For example, there may be Trustee representations included in the application form, sometimes going as far as warranties that the Trustees have read ALL the documentation relating to the pooled fund, and that the terms of the fund are enforceable and form a valid contract (as well as that they have the requisite power to enter into the contract).

Greater care is needed when the LDI is on a segregated basis. In that case the LDI manager will often have authority to enter derivatives on the trustees' behalf. The investment management agreement (IMA) between the trustees and the LDI manager will typically contain representations from the trustees that they have legal power to enter into the types of derivatives the manager is planning to use. The derivatives contracts will also contain similar representations in favour of the bank counterparties, and banks will generally rely on these representations rather than looking behind them. So it is absolutely essential that the IMA correctly sets out the types of derivatives that the manager is expecting to use, and that the representations that the trustees give in the IMA and the derivatives documents are correct.

What action should trustees take? If you already have derivatives contracts, whether entered into directly or through an LDI manager, check the investment powers in your trust deed and make sure these are wide enough to cover the particular types of derivatives that the manager is authorised to use. This check can be carried out relatively quickly and easily, but could save a huge amount of complication and risk. And if you are looking to use derivatives in the future, make absolutely sure you carry out this check before you embark on appointing the LDI manager.

Could Trustees be sued even if they haven't the assets to meet a claim in full? For UK pension trustees, if they acted outside their powers, members would need to show loss and establish the legal cause of action (contractual, breach of trust and/or negligence), and overcome any protections which the trustees might rely on under their trust constitution.



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 October 2014

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	-0.7	-1.4	1.0	10.8	10.0	8.0	7.7
Overseas Equities	2.3	5.8	9.5	14.3	12.0	9.5	7.5
US Equities	3.7	10.6	17.5	20.2	17.4	10.0	8.4
Europe ex UK Equities	-1.4	-0.1	-1.6	11.1	6.7	8.3	9.8
Japan Equities	-0.1	1.1	0.2	9.3	6.6	4.9	0.1
Pacific ex Japan Equities	4.0	1.7	5.1	8.1	8.7	13.0	6.6
Emerging Markets	2.5	1.1	1.4	3.9	5.6	12.4	5.9
UK Long-dated Gilts	1.7	6.7	12.1	6.0	8.1	6.9	8.4
UK Long-dated Corp. Bonds	0.5	4.2	9.1	8.6	8.9	6.5	-
UK Over 5 Yrs Index-Linked Gilts	1.9	6.9	10.0	7.9	8.7	7.7	8.0
High Yield (Global)	1.9	4.1	4.8	9.7	10.6	9.8	-
Overseas Bonds	1.2	2.7	-0.8	-0.7	2.3	5.3	5.5
Property *	1.7	4.7	19.7	9.6	11.9	5.8	8.3
Cash	0.0	0.1	0.5	0.7	0.7	2.7	4.2
Commodities £-converted	-4.7	-8.3	-11.6	-4.9	-0.5	-2.4	3.4
Hedge Funds original \$ basis *	-0.9	-0.3	6.5	6.4	5.1	5.7	8.7
Illustrative £-converted version *	1.6	5.2	6.4	5.0	4.8	6.8	8.5
Euro relative to Sterling	0.5	-1.2	-7.4	-3.2	-2.6	1.2	-
US \$ relative to Sterling	1.3	5.5	0.4	0.3	0.6	1.4	0.1
Japanese Yen relative to Sterling	-0.9	-3.2	-12.2	-11.1	-3.6	0.8	-0.6
Sterling trade weighted	-0.6	-0.8	6.2	3.0	1.6	-1.3	0.0
Price Inflation (RPI) *	0.2	0.5	2.3	2.7	3.7	3.2	2.9
Price Inflation (CPI) *	0.1	0.1	1.3	2.0	2.9	2.7	2.1
Price Inflation (RPIX) *	0.2	0.5	2.3	2.7	3.7	3.4	2.9
Earnings Inflation **	-0.7	-1.3	0.8	1.3	1.6	2.5	3.2
All Share Capital Growth	-0.9	-2.3	-2.3	7.0	6.3	4.3	4.2
Net Dividend Growth	0.0	-0.2	0.4	7.3	6.1	5.1	-
Earnings Growth	-5.0	-5.2	11.6	-4.1	10.5	4.7	5.3

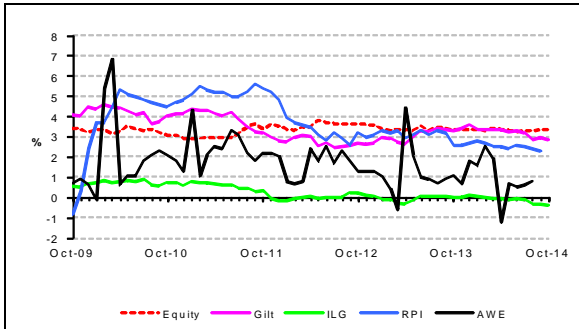
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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.

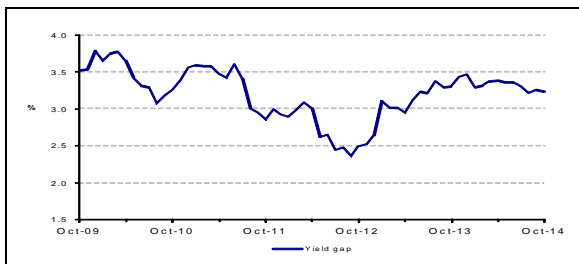


Yields and Yield Gaps

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.

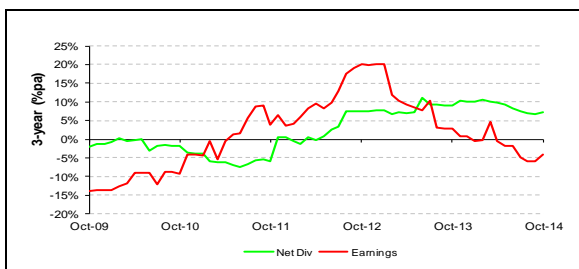
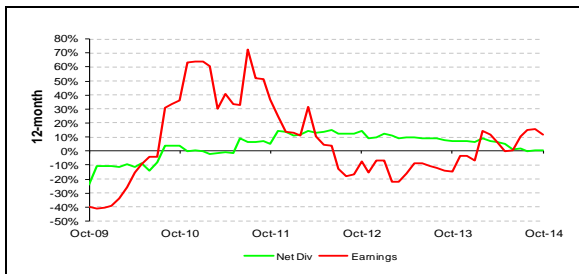


The gap gives a current expectation now around 3.2% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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]

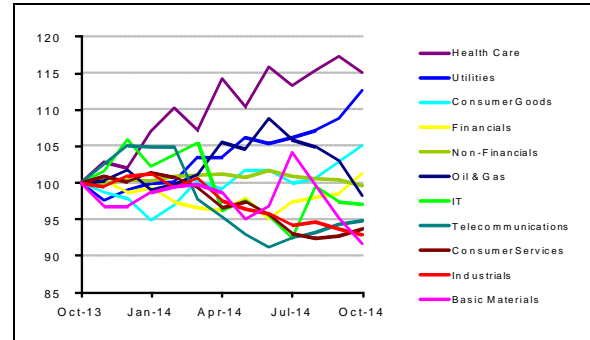
Figure 3: Dividend & Earnings Growth



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



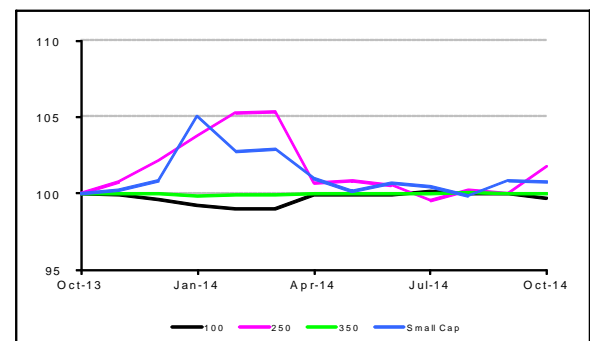
Note: Sector labels for relative lines are in end-value order

There was a slight rise this month in the rolling 12-month sector dispersion (from 22% to 23%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	-5.3	-8.6	-0.9
Basic Materials	-4.4	-13.3	-7.5
Industrials	-1.7	-2.8	-6.2
Consumer Goods	1.5	3.7	6.2
Health Care	-2.6	0.2	16.3
Consumer Services	0.3	-0.7	-5.4
Telecommunications	-0.2	1.2	-4.2
Utilities	2.8	4.6	13.8
Non-Financials	-1.6	-2.6	0.6
Financials	2.0	2.4	2.2
IT	-1.0	3.7	-1.9
All Share	-0.7	-1.4	1.0

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Mid Cap rose, in relative terms this month, but Small Cap fell very slightly.

FRS17 volatility indicator

Now discontinued, but available on request.



Bond market information

Figure 5: £ Non-Gilt Credit Margins

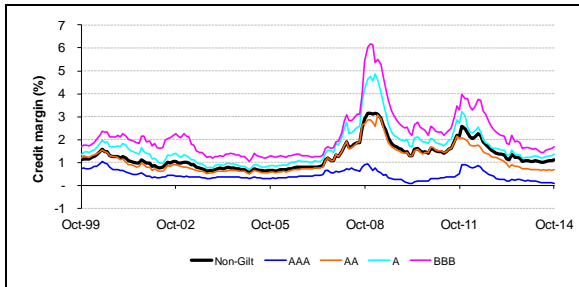


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
May '14	4.07	3.26	0.81
Jun '14	4.12	3.31	0.81
Jul '14	4.04	3.21	0.83
Aug '14	3.70	2.86	0.84
Sep '14	3.80	2.95	0.85
Oct '14	3.76	2.85	0.91

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

Category	Mkt Val @ Oct 14 & 11, 08			Weight (%)
	Oct 14	Oct 11	08	
Gilts (39)	1,153	928	446	67.9
Non Gilts (1,054)	546	473	399	32.1
AAA (129)	104	129	149	6.1
AA (178)	91	78	70	5.3
A (361)	175	163	119	10.3
BBB (386)	176	103	58	10.4

Category	Mkt Val @ Oct 14, & 11		W't (%)	Dur'n (yrs)
Gilts (39)	1,153	928	67.9	10.1
< 5 Yrs (11)	334	270	19.7	3.0
5-15 Yrs (12)	359	294	21.1	7.3
> 15 Yrs (16)	459	364	27.0	17.4
Non Gilts (1,054)	546	473	32.1	8.0
< 5 Yrs (337)	160	122	9.4	2.6
5-15 Yrs (451)	231	205	13.6	7.6
> 15 Yrs (266)	154	147	9.1	14.1

£ Gilt Market “main” Issuance

- o £4.40bn 2% 2020 (1.51x, 1.93%, Sep 14)
 - o £3.00bn 2¾% 2024 (1.71x, 2.15%, Aug 14)
 - o £2.47bn 3½% 2045 (1.97x, 3.04%, Sep 14)
 - o £4.00bn 3½% **2068** (3.57x, 2.97%, Oct 13)
 - o £1.40bn ILG 1/8% 2024 (1.95x, r.y -0.71%, Jul 14)
- Note: Issuance amounts are nominals.

Tables 2d, 2e: € Market Size and Maturity (Oct 14)

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (286)	5,321	59.8
Non Sovereigns	3,572	40.2
AAA (549)	1,047	11.8
AA (490)	834	9.4
A (784)	851	9.6
BBB (822)	840	9.4

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (809)	2,191	24.6
3 – 5 Yrs (705)	1,784	20.1
5 – 7 Yrs (630)	1,608	18.1
7 – 10 Yrs (525)	1,575	17.7
10+ Yrs (262)	1,735	19.5

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Oct 14 & 11)		W't (%)	Dur'n (yrs)
Gilts (24)	446	305	92.7	19.7
< 5 Yrs (2)	44	49	9.1	-
5 – 15 Yrs (7)	135	84	28.2	-
> 15 Yrs (15)	267	172	55.5	28.0
Non Gilts (43)	35	27	7.3	16.9

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

Month End	US (%)	Euro (%)	Sterling (%)
Apr '14	5.31	4.01	5.39
May '14	5.21	3.94	5.43
Jun '14	5.16	3.91	5.51
Jul '14	5.55	4.04	5.72
Aug '14	5.32	3.94	5.63
Sep '14	5.80	4.05	5.87
Oct '14	5.59	4.08	6.27

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

