JAGGER & ASSOCIATES

Investment Update
March 2014

Investment Headlines & Comment

- The Government is set to bar transfers out from public sector DB schemes to any DC schemes.
- They are consulting on extending this to private sector DB transfers out to DC schemes as well.
- An irony in that small DB tranches could be stuck, versus the plan for consolidation of small DC pots?

Feature Section

This month we pick up on the outpourings that have resulted from the Budget's plan to abandon any obligation for "defined contribution" (DC) arrangements to purchase annuities at or during retirement. (Until 2011's "flexible drawdown" with a requirement of a minimum income of £20k p.a., it was commonly thought annuities automatically had to come into play at age 75, even if income drawdown had been used as a means to avoid them at the point of retirement.)

Our June 2012 issue covered some of the savings-related issues associated with DC pots, as well as the then publication of guidance from the Pension Regulator. We concluded by wondering if DC members would be willing to take any investment volatility, once their savings pots got anywhere near the levels of eight to ten times their salaries. To that we can now add the question of whatever they will do with the freedom to withdraw cash above the existing 25% (albeit at their marginal tax rate), even if it comes with "free face-to-face investment advice" from the pension scheme or savings provider. (Can the resource for that advice be created quickly enough, and is there a risk that it cuts corners, because the member is not paying? Or worse, for savings providers, is the greater risk that the advice is seen as conflicted because of the desire to earn further fees on the savings pots? Making the advice face-to-face is unlikely to reduce the risk.)

Being morbid actuaries, to us the question of tax on death comes into play pretty quickly, followed by the question of care home fees. At the moment, a single pensioner dying in (full) income drawdown is subject to a tax charge of 55% on any pot money not yet converted to an annuity or paid to a charity. Those dying whilst using phased drawdown are not subject to that charge on the portion not yet in drawdown. (Who thought it was simple at the moment? We haven't even mentioned Lifetime and Annual Allowance technicalities.) Spouses of deceased pensioners can either continue the income drawdown, or use the residual fund to purchase an annuity – however, if they continue with drawdown, then the 55% hits their residual pot if they die before securing an annuity or pass to a charity. Interestingly, the Budget plan does *not* contain detail on the revised tax rate to be applied on death, beyond noting "a flat 55% rate will be too high in many cases" (p20). A second reason for not wanting to have too much in the way of assets is their potential eradication in care home fees – having a steady sequence of annuity payments is a good hedge against this, but the Budget plan observes that the industry is likely to develop new products for this (p23).

Other than for those savers with substantial pots, we suspect that some "rules of thumb" will emerge. For example, with a pot of £100k, £25k could be taken tax-free, and the remaining £75k, if taken as cash in a single tax year, would probably attract a mix of 20% tax and 40% tax. The average tax rate may not seem too bad, and thus many people may take all the post-tax-free-cash pot as cash, preferring the comfort of having the money for themselves. However, if the pot is somewhat larger, then it is more likely that more penal tax rates would become involved (for example, the loss of the personal allowance on income over £100k, and then the current Coalition's 45% or Labour's proposed 50% rate applying from £150k onwards). So, for those cases over £100k, *some* of the post-tax-free-cash pot might still be taken, but the proportion taken could well decline as the pot size increases. (Think of a £500k pot, for example.)

Away from these technicalities, some commentators have claimed that the change makes current default strategies no longer fit for purpose. However, to us the issue seems to be more about whether members will have scope for choice away from their provider's default both in terms of retirement age and funds used. There will still be a need for the default strategy to exist (some members will always fail to make decisions), and the start point of targeting 25% cash and a bond portfolio to draw down from at a pre-specified age is perfectly reasonable. For those with small pots wanting to utilize the "take all as a lump sum" approach, they can deviate towards a 100% cash strategy just before retirement. Similarly, those wanting to take more risk in their drawdown portfolio could adapt their approach accordingly, by slowing down their switching into traditionally defensive assets.

Following on from this "take more risk" point, some have claimed that people will be invested in equities for longer. This may perhaps be true in some cases, but by no means all. A "low volatility" drawdown portfolio could reasonably be constructed combining corporate bonds, units in property funds, and some equities (with or without an income bias), or members could use absolute return funds. See our July 2013 issue for discussion of those. DC savers could also adopt a mix of an annuity (for comfort) and an absolute return fund (for upside). With so many choices, however will these savers manage to be DC-isive? Consultation on the changes runs until June 2014, for those wishing to chip in.

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 March 2014

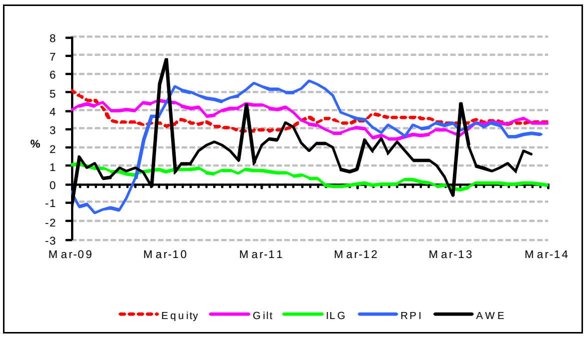
Asset Class	1 month (%)	3 months (%)	12 months (%)	3 years (% p.a.)	5 years (% p.a.)	10 years (% p.a.)	20 years (% p.a.)
UK Equities	**-2.6**	-0.6	8.8	8.8	16.4	8.6	7.7
Overseas Equities	1.4	0.7	6.8	7.6	14.9	8.8	7.0
US Equities	1.3	1.2	11.3	**13.3**	**17.6**	8.8	8.4
Europe ex UK Equities	0.7	2.4	**15.7**	6.1	14.2	9.6	**8.9**
Japan Equities	-0.6	**-6.0**	-1.6	4.3	7.2	3.2	**-0.4**
Pacific ex Japan Equities	2.6	0.4	-6.5	0.8	14.4	**12.1**	6.2
Emerging Markets	**3.6**	-1.0	**-9.9**	**-3.8**	11.4	11.6	5.9
UK Long-dated Gilts	0.1	3.4	-3.1	8.7	6.5	6.1	7.6
UK Long-dated Corp. Bonds	-0.4	2.7	1.1	8.9	10.7	6.0	-
UK Over 5 Yrs Index-Linked Gilts	1.7	3.6	-4.4	9.0	8.8	7.1	7.4
High Yield (Global)	0.8	2.2	-0.8	7.6	15.5	10.0	-
Overseas Bonds	0.3	2.0	-8.5	0.3	**0.6**	5.4	5.0
Property *	1.1	**4.4**	12.6	7.4	9.0	5.8	8.1
Cash	0.0	0.1	0.5	0.7	0.7	**2.9**	4.3
Commodities £-converted	0.7	2.3	-7.9	-4.7	3.7	1.0	3.6
Hedge Funds original $ basis *	2.0	2.5	7.9	3.2	8.4	5.5	8.8
Illustrative £-converted version *	0.0	0.2	-2.3	2.2	4.9	6.6	8.2
Euro relative to Sterling	0.2	-0.7	-2.3	-2.3	-2.2	2.1	-
US $ relative to Sterling	0.5	-0.7	-8.9	-1.3	-3.0	1.0	-0.6
Japanese Yen relative to Sterling	-0.4	1.4	-16.8	-8.2	-3.8	1.1	-0.6
Sterling trade weighted	-0.5	1.1	7.2	2.8	2.2	-1.7	0.1
Price Inflation (RPI) *	0.6	0.8	2.7	3.2	3.8	3.3	3.0
Price Inflation (CPI) *	0.6	0.3	1.8	2.6	3.1	2.7	2.2
Price Inflation (RPIX) *	0.7	0.8	2.7	3.2	3.9	3.4	2.9
Earnings Inflation **	0.5	3.7	1.6	1.2	1.5	2.4	3.5
All Share Capital Growth	-3.0	-1.5	5.2	5.0	12.4	4.9	4.2
Net Dividend Growth	-0.1	2.4	7.1	10.1	3.6	5.8	-
Earnings Growth	-2.6	2.6	11.9	4.8	2.1	7.0	6.1

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



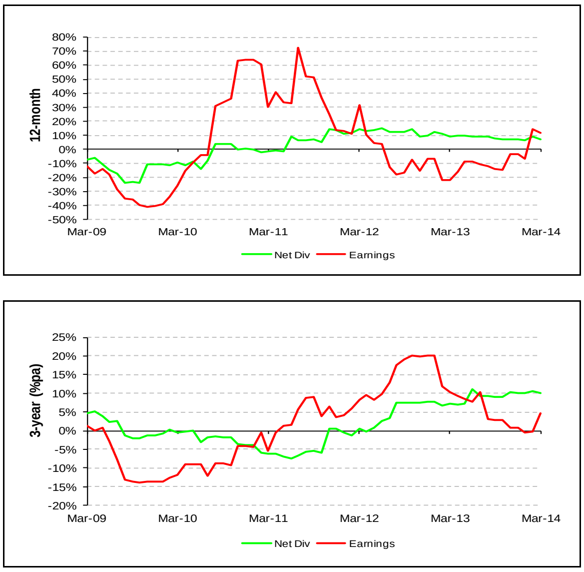
The yield gap is a measure of expected average future inflation, derived as long bond yield minus ILG yield.

The gap gives a current expectation now nudging towards 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*]

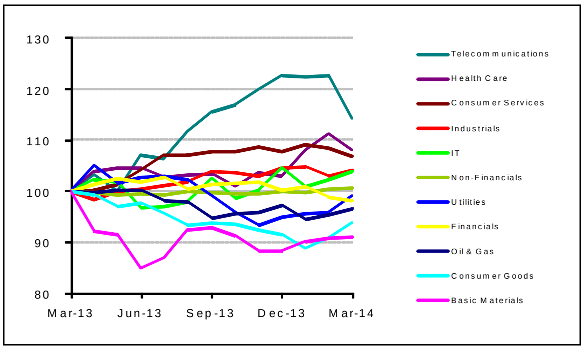
Figure 3: Dividend & Earnings Growth



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



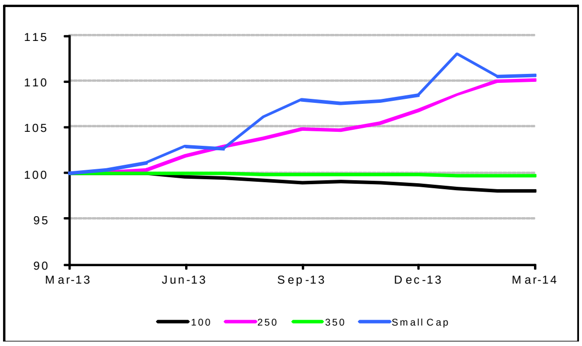
Note: Sector labels for relative lines are in end-value order

There was a large fall this month in the rolling 12-month sector dispersion (from 52% to 23%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	-1.4	-1.2	5.0
Basic Materials	-2.3	2.4	-0.9
Industrials	-1.4	-1.0	13.3
Consumer Goods	0.7	1.8	2.1
Health Care	-5.3	4.4	17.6
Consumer Services	-4.0	-1.3	16.3
Telecommunications	-9.3	-7.6	24.2
Utilities	0.7	3.8	7.8
Non-Financials	-2.4	0.1	9.5
Financials	-3.4	-2.8	6.7
IT	-1.0	-1.1	13.1
All Share	-2.6	-0.6	8.8

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Mid Cap and Small Cap were both "flat", in relative terms this month.

FRS17 volatility indicator

Now discontinued, but available on request.

Bond market information

Figure 5: £ Non-Gilt Credit Margins

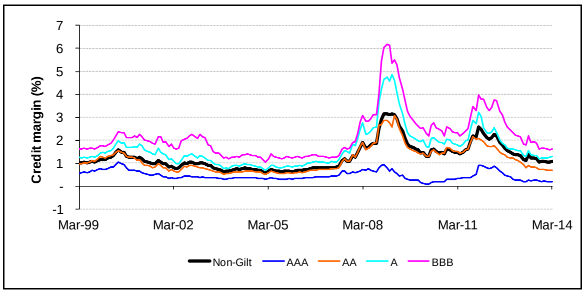


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
Oct '13	4.13	3.29	0.84
Nov '13	4.28	3.44	0.84
Dec '13	4.37	3.57	0.80
Jan '14	4.19	3.34	0.85
Feb '14	4.17	3.35	0.82
Mar '14	**4.25**	**3.35**	**0.90**

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

Category	Mkt Val @ Mar 14	& 11	08	Weight (%)
Gilts (37)	1,070	815	339	67.1
Non Gilts (1,040)	524	464	410	32.9
AAA (128)	100	129	157	6.3
AA (173)	86	72	60	5.4
A (357)	169	162	126	10.6
BBB (382)	169	100	64	10.6

Category	Mkt Val @ Mar 14	& 11	W't (%)	Dur'n (yrs)
Gilts (37)	1,070	815	67.1	9.6
< 5 Yrs (9)	269	261	16.9	2.7
5–15 Yrs (13)	405	268	25.4	7.0
> 15 Yrs (15)	396	286	24.9	17.0
Non Gilts (1,040)	524	464	32.9	7.9
< 5 Yrs (321)	151	126	9.5	2.7
5–15 Yrs (448)	225	201	14.1	7.5
> 15 Yrs (271)	148	136	9.3	13.6

£ Gilt Market "main" Issuance

- £4.30bn 1¾% 2019 (1.68x, 1.89%, Feb 14)
- £3.28bn 2¾% 2024 (2.24x, 2.93%, new)
- £1.59bn ILG $^{1}/_{8}$% 2019 (2.47x, r.y -0.93%, Oct 13)
- £0.90bn ILG ¼% 2052 (1.70x, r.y -0.03%, Nov 13)

Note: Issuance amounts are nominals.

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

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (283)	5.018	59.8
Non Sovereigns	3,377	40.2
AAA (530)	1,016	12.1
AA (446)	738	8.8
A (767)	833	9.9
BBB (773)	791	9.4

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (806)	2,201	26.2
3 – 5 Yrs (706)	1,722	20.5
5 – 7 Yrs (558)	1,382	16.5
7 – 10 Yrs (496)	1,571	18.7
10+ Yrs (233)	1,518	18.1

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Mar 14	& 11)	W't (%)	Dur'n (yrs)
Gilts (23)	396	254	92.4	19.2
< 5 Yrs (2)	44	22	10.3	2.8
5 – 15 Yrs (7)	124	99	29.1	9.5
> 15 Yrs (14)	227	133	53.0	27.7
Non Gilts (43)	33	25	7.6	16.9

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

Month End	US (%)	Euro (%)	Sterling (%)
Sep '13	6.06	5.04	6.19
Oct '13	5.66	4.64	5.85
Nov '13	5.67	4.54	5.79
Dec '13	5.67	4.52	5.75
Jan '14	5.63	4.41	5.65
Feb '14	5.37	4.16	5.50
Mar '14	**5.40**	**4.11**	**5.45**

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

JAGGER & ASSOCIATES

Contact: Ground Floor, 14 Exchange Quay,
Salford Quays, Manchester M5 3EQ
Tel.: 0161 873 9350, Fax: 0161 877 4851
web: www.jaggerandassociates.co.uk ,
e-mail: enquiries@jaggerandassociates.co.uk

See our website for details of the investment consultancy services we provide to actuarial firms, pension funds, universities and other endowment funds, and charities.