JAGGER & ASSOCIATES

Investment Update
April 2014

Investment Headlines & Comment

- The formalities for **Aberdeen** buying **SWIP** have been completed
- The resulting integration has seen the exit of 4 senior SWIP staff.
- Meanwhile, the OFT is reviewing the purchase of **F&C** by **BMO**.

Feature Section

This month we welcome a guest contributor, Brigid Jackson of Legal & General (L&G), who considers some current quirks of High Yield (sub-investment grade) bonds. We last considered the asset class in our March 2013 issue, looking at historic default rates. This time, the subject is the choice of quoted yield. Unlike for gilts, the redemption yield may not be all it seems.

A bond's *yield to maturity* (YTM), also known as its redemption yield, factors in a bond's coupon rate, price, term to maturity and an assumption about how much principal will be repaid on maturity, usually par. However, for certain types of bond, some of these factors may be variable. For example, a callable bond can be called (or repaid) by the issuer prior to the bond's maturity date. The benefit for issuers is that if their borrowing costs are falling, they can call the original bond and issue a new bond at a lower rate of interest. The estimated yield an investor would receive if the bond is called is its *yield to call* (YTC). If a bond is likely to be called, YTC is a more accurate measure of return than YTM. *Yield to worst* (YTW) is the lower of yield to maturity and yield to call. It is the lowest potential yield that can be received on a bond without the issuer defaulting. It is therefore relevant to investors when assessing risk and levels of achievable income. (YTW is not generally quoted for Sterling or Euro investment grade, as only 6% of these companies' bonds are callable, but interestingly, that figure rises to 29% for US companies. Within High Yield "non-financials", callable is much higher: 63% for Europe, 70% for Sterling and 75% for US.)

If there is an expectation that a bond will be called, the YTC diverges from yield to maturity, and the YTW falls (the red line in Figure 1a illustrates this on a global high yield index – *sources: Bloomberg, BofAML*). This divergence is inversely correlated to refinancing rates – calls increase when rates are falling. Very low interest rates since the credit crisis have had a dual impact on the high yield bond markets: investors have been encouraged into riskier asset classes in their search for income, boosting demand for high yield and creating a willing audience for issuers refinancing their debt. As demand has driven bond prices higher, yields have fallen and bond issuers have been able to refinance their debt at lower yields to reduce their interest rate costs (the blue line). This trend has been the same across US, European, UK and emerging markets high yield – and also investment grade. If a bond can be called to result in a new lower-coupon bond, then in general it will be, unless market conditions make this impractical.

At the same time, high yield bonds are generally being issued with shorter maturities. For example, at the beginning of 2006, UK chemicals company Ineos issued a ten year bond with a 7.875% coupon. The bond was called this year, and Ineos issued a five year bond paying a 5.875% coupon to refinance the existing debt. This is illustrative of a general trend L&G observe in new issuance. As a result of both these trends – shorter maturity issuance and more bonds being called in recent years – the weighted average maturity to worst (i.e. to call if that is expected earlier than final maturity) of global BB-B rated bonds has fallen from around eight years at the end of the 1990s to below five years today.

Over the last two years, spreads across developed markets have compressed (Figure 1b – *sources: Bloomberg, BofAML*), and across different ratings categories. This suggests that there is now less opportunity to add value from sector rotation (overweighting the UK and Europe or CCCs for example), than a year ago when the average European B-rated bond had a yield around 5% higher than an equivalently-rated US bond. Global funds which look across emerging markets will still find opportunities to add value – emerging markets spreads have diverged from the spread tightening in developed markets ever since last summer, largely due to idiosyncratic risks such as political unrest, currency devaluation, or knock-on effects from Fed tapering.

Figure 1a: Trends in coupons and yield gap

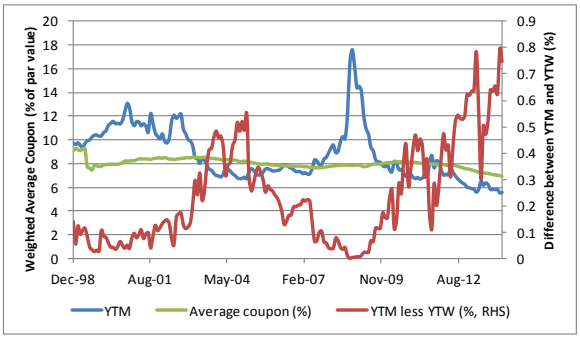
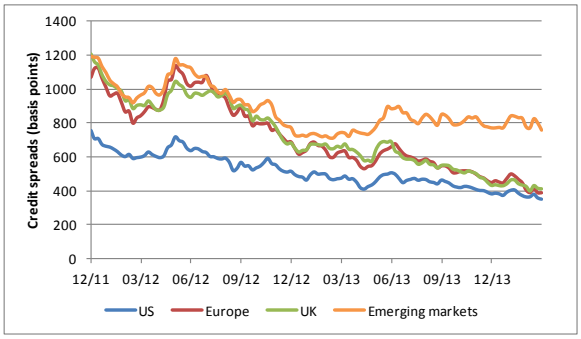


Figure 1b: Trends in credit spreads (B-rated)



In a lower yield, lower spread environment, successfully earning a return of 1 to 2% ahead of benchmark becomes a proportionately greater component of investors' total returns. Spread compression between sectors suggests that at this point in the credit cycle, managers will have to work hard to find differentiating sources of alpha within developed markets. However, as Figure 1b suggests, there could well be interesting opportunities within emerging markets. The current high spreads price in a fairly material slow down in China which L&G think unlikely.

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 April 2014

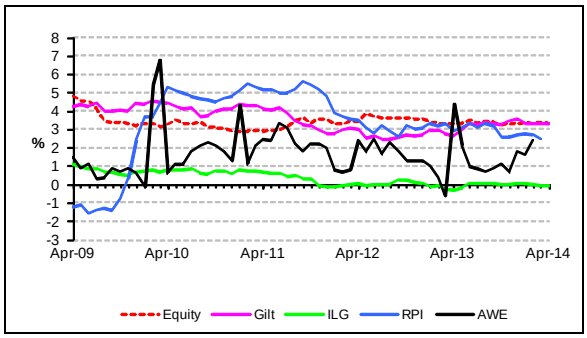
Asset Class	1 month (%)	3 months (%)	12 months (%)	3 years (% p.a.)	5 years (% p.a.)	10 years (% p.a.)	20 years (% p.a.)
UK Equities	**2.2**	4.7	10.5	8.5	14.7	8.6	7.8
Overseas Equities	-0.6	3.4	5.7	7.5	13.0	8.7	6.9
US Equities	-0.6	3.3	11.2	**13.5**	**16.1**	8.5	8.3
Europe ex UK Equities	0.2	**5.9**	13.3	4.8	11.7	9.3	**9.0**
Japan Equities	**-3.8**	**-6.7**	**-10.7**	4.2	5.1	**2.9**	**-0.6**
Pacific ex Japan Equities	-0.2	4.8	-6.7	0.6	11.8	**12.3**	6.1
Emerging Markets	-0.9	4.0	-9.2	**-3.8**	8.6	11.8	5.9
UK Long-dated Gilts	1.3	1.6	-4.1	8.1	7.3	6.5	7.8
UK Long-dated Corp. Bonds	1.7	1.8	-1.4	8.5	11.2	6.3	-
UK Over 5 Yrs Index-Linked Gilts	1.0	2.8	-4.7	8.6	9.1	7.3	7.5
High Yield (Global)	-0.3	1.0	-0.9	8.1	13.8	9.7	-
Overseas Bonds	-0.2	-0.7	-7.1	0.6	1.3	5.4	5.1
Property *	1.6	3.9	**14.0**	7.6	9.9	5.7	8.1
Cash	0.0	0.1	0.5	0.7	**0.7**	**2.9**	4.3
Commodities £-converted	-0.6	2.6	-1.5	-4.9	4.4	0.4	3.5
Hedge Funds original $ basis *	-0.3	1.0	6.5	3.0	8.0	5.4	8.9
Illustrative £-converted version *	0.2	0.4	-3.1	1.7	4.7	6.5	8.2
Euro relative to Sterling	-0.7	0.1	-3.1	-2.6	-1.7	2.0	-
US $ relative to Sterling	-1.3	-2.7	-7.9	-0.4	-2.6	0.5	-0.5
Japanese Yen relative to Sterling	-0.5	-2.8	-12.1	-7.8	-3.3	1.3	-0.6
Sterling trade weighted	1.0	1.0	7.3	2.9	1.9	-1.5	0.0
Price Inflation (RPI) *	0.2	0.6	2.5	3.1	3.8	3.3	2.9
Price Inflation (CPI) *	0.2	0.2	1.7	2.6	3.1	2.7	2.2
Price Inflation (RPIX) *	0.3	0.6	2.5	3.2	3.9	3.4	2.9
Earnings Inflation **	5.0	9.0	2.4	1.2	1.9	2.8	3.6
All Share Capital Growth	1.8	3.5	6.8	4.7	10.7	4.9	4.2
Net Dividend Growth	0.0	2.6	6.5	9.7	3.0	5.8	-
Earnings Growth	1.3	7.2	6.1	-0.6	3.3	7.3	6.0

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

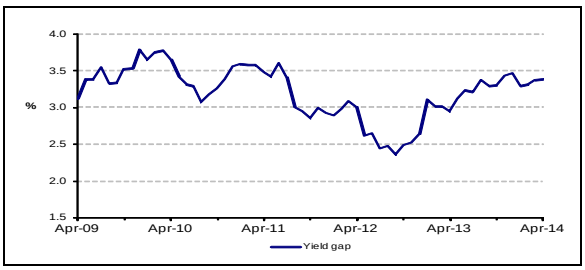
- *UK Equities (incl. dividends and earnings) – FT-A All Share.*
- *Overseas Equities (incl. regions) – blend of FT All-World / World subindices*
- *Emerging Markets from MSCI US $ based total return index (overall Index to 31 Oct 2001, Free Index from 1 Nov 2001 to take account of foreign investment 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.

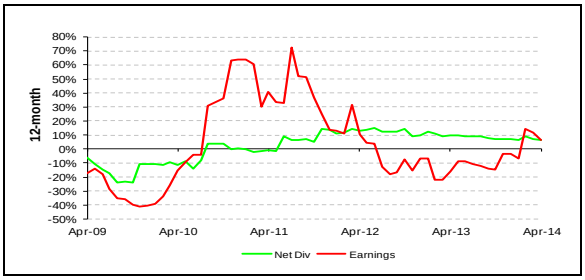


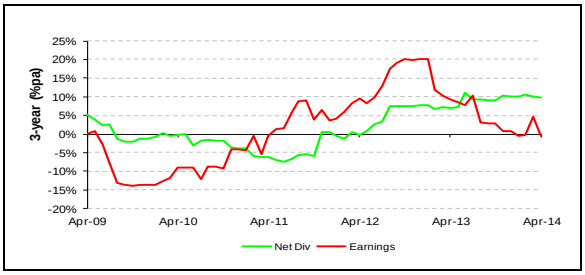
The gap gives a current expectation now just below 3.5% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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

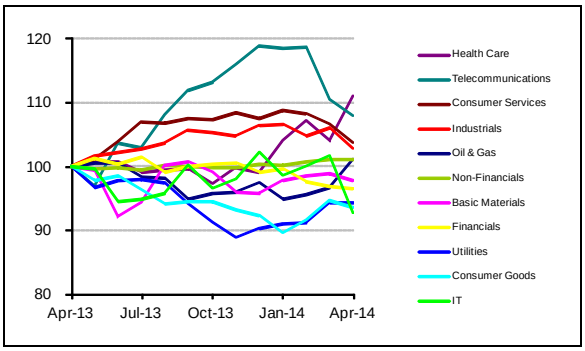




Sources for charts on this page:
Financial Times, Office for National Statistics, J&A

UK Equity Sector Returns

Figure 4a: Sectors relative to All Share



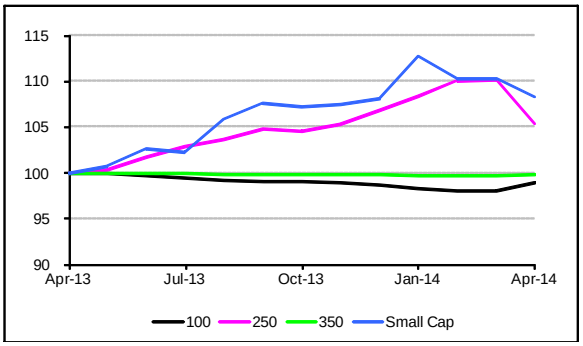
Note: Sector labels for relative lines are in end-value order

There was a further fall this month in the rolling 12-month sector dispersion (from 23% to 18%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	6.8	11.8	11.8
Basic Materials	1.2	4.8	8.2
Industrials	-0.9	1.0	13.6
Consumer Goods	1.1	9.5	3.5
Health Care	8.9	11.8	22.6
Consumer Services	-0.7	-0.3	14.6
Telecommunications	-0.3	-4.8	19.2
Utilities	2.1	8.4	4.2
Non-Financials	2.3	5.8	11.8
Financials	1.8	1.5	6.7
IT	-6.9	-1.6	2.4
All Share	2.2	4.7	10.5

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



Mid Cap fell markedly and Small Cap fell slightly, in relative terms this month.

FRS17 volatility indicator

Now discontinued, but available on request.

Bond market information

Figure 5: £ Non-Gilt Credit Margins

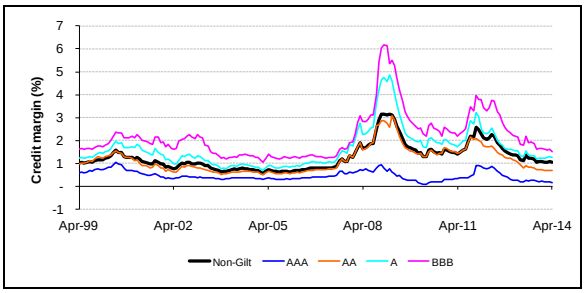


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
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
Apr '14	**4.17**	**3.34**	**0.83**

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

Category	Mkt Val @ Apr 14 & 11, 08			Weight (%)
Gilts (38)	1,085	811	347	67.2
Non Gilts (1,041)	530	468	422	32.8
AAA (129)	101	127	160	6.3
AA (173)	87	74	63	5.4
A (355)	169	165	131	10.5
BBB (384)	172	102	65	10.7

Category	Mkt Val @ Apr 14, & 11		W't (%)	Dur'n (yrs)
Gilts (38)	1,085	811	67.2	9.6
< 5 Yrs (10)	309	239	19.1	2.9
5–15 Yrs (13)	375	276	23.2	7.2
> 15 Yrs (15)	401	297	24.9	17.0
Non Gilts (1,041)	530	468	32.8	7.9
< 5 Yrs (322)	153	120	9.5	2.7
5–15 Yrs (447)	226	208	14.0	7.5
> 15 Yrs (272)	151	139	9.4	13.7

£ Gilt Market "main" Issuance

- £4.00bn 1¾% 2019 (1.77x, 1.95%, Mar 14)
- £3.50bn 2¾% 2024 (1.74x, 2.82%, Mar 14)
- £2.72bn 3¼% 2044 (1.84x, 3.53%, Jan 14)
- £1.30bn ILG ¾% 2034 (1.85x, r.y 0.01%, Aug 13)

Note: Issuance amounts are nominals.

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

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (282)	5,075	59.8
Non Sovereigns	3,418	40.2
AAA (539)	1,034	12.2
AA (452)	756	8.9
A (772)	838	9.9
BBB (765)	789	9.3

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (813)	2,197	25.9
3 – 5 Yrs (692)	1,761	20.7
5 – 7 Yrs (575)	1,403	16.5
7 – 10 Yrs (491)	1,588	18.7
10+ Yrs (239)	1,544	18.2

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Apr 14 & 11)		W't (%)	Dur'n (yrs)
Gilts (23)	401	260	92.4	19.2
< 5 Yrs (2)	44	22	10.2	2.7
5 – 15 Yrs (7)	125	101	28.9	9.5
> 15 Yrs (14)	231	138	53.3	27.6
Non Gilts (43)	33	25	7.6	16.9

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

Month End	US (%)	Euro (%)	Sterling (%)
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
Apr '14	**5.31**	**4.01**	**5.39**

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

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