



Investment Update September 2014

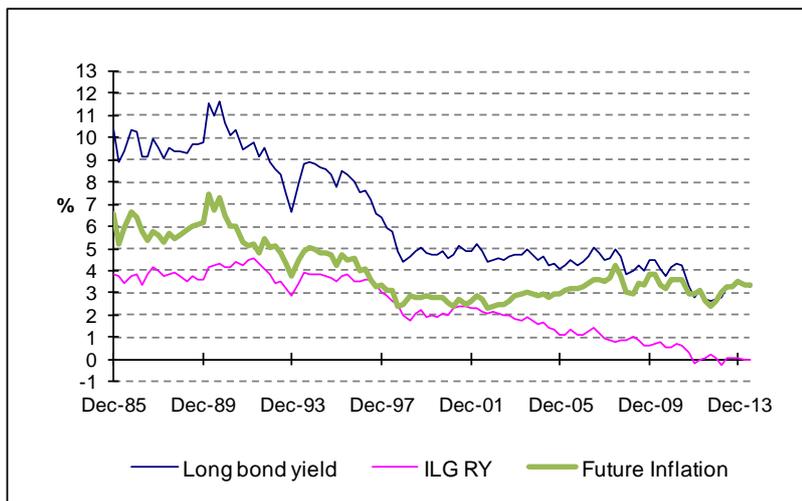
Investment Headlines & Comment

- A poor month for most assets, particularly **Commodities** and **Emerging Markets**. Bond yields rose from their August lows.
- The co-founder of **PIMCO**, Bill Gross, has left abruptly, after recent weak results for his bond-based Total Return fund.
- **Argentina** has been dropped from FTSE's Global Equity indices entirely (it was previously classed as a Frontier market).

Feature Section This month we revisit another fashionable area, Liability Driven Investment (LDI). Back in our November 2005 [edition](#), we outlined the theory of LDI for defined benefit pension schemes, and in our May 2006 [edition](#) a guest contributor, Keith Wallace, set out his concerns on how LDI was being overly "sold". In our December 2007 [edition](#), we considered whether LDI strategies had paid off during that calendar year, and found that they probably had not.

The nub of LDI is that it essentially fixes your exposure to interest rates and inflation on your chosen proportion of your scheme, although it will usually achieve this at rates worse than assumed in actuarial valuations. Thus, you may expect an initial worsening of your funding level, but if interest rates fall after you have implemented, you avoid a (net) increase in your liabilities, and if (typically long-term) inflation expectations rise after you have implemented, you again avoid a (net) increase in your liabilities. Conversely, if interest rates rise or inflation expectations fall, you face (net) losses compared to if you had not implemented LDI, *but* you may (or may not) regard that as a price worth paying for the comfort you would have had if the movements had been in the opposite direction.

Figure 1: Long term yields and implied inflation



Sources: FTSE, Jagger & Associates

how much LDI to implement, and when. A typical approach starts by testing what proportion of interest rate and inflation exposure is covered by a scheme's existing strategy. It would then identify what those proportions could rise to by restructuring the existing bond holdings of the scheme into LDI funds (or their segregated equivalent). Hence, you would establish the additional assets needed to be switched to (or from) LDI funds in order to achieve particular desired proportions (usually a switch to LDI, if the desired proportions are in the 75% to 100% range, thus reducing the assets available to invest towards deficit reduction). You can also identify how much of the assets could be released on a conversion to LDI, if the existing strategy's proportions were felt to be sufficient. However, the timing of any implementation remains a key consideration.

Moreover, once pension schemes have gone into LDI, it still seems comparatively rare for them to unwind their LDI (e.g. to bank any net profits from having protected themselves against falls in long-term interest rates). To borrow Hilaire Belloc's phrase, it seems "[they] always keep a hold of Nurse, for fear of finding something worse". Yet, the more asymmetric the risks appear to be (e.g. for ILGs with their negative real yields, which provide no "incentive to save"), then perhaps the more urgently that some Trustees should consider unwinding those components of LDI positions where exceptional gains have been created by the general Gadarene rush into LDI?

Figure 1 shows how long-dated nominal and real interest rates have fallen. The trend for implied long-term RPI inflation is less clear cut after 1997, with it being pretty stable for about 8 years, and then varying within a slightly wider band (but generally taking values well ahead of the target level set for the Bank of England).

Schemes that implemented LDI in (say) early 2008 have benefited since then from interest rate protection but they have probably suffered on their inflation protection. Indeed, recently, some investors using pooled LDI funds to fix their long-dated inflation exposure have faced additional demands for collateral in order to keep the protection in place.

The increased range of modeling now available to Trustees can help determine



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 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	-2.8	-1.0	6.1	13.9	9.7	8.2	7.9
Overseas Equities	-0.6	3.5	12.3	16.0	10.4	9.4	7.4
US Equities	0.8	6.4	19.3	21.5	15.4	9.6	8.5
Europe ex UK Equities	-0.8	-2.6	5.3	14.6	5.9	8.8	9.5
Japan Equities	1.7	3.1	1.2	8.0	5.4	5.0	0.1
Pacific ex Japan Equities	-4.7	2.4	6.6	9.8	7.1	12.7	6.2
Emerging Markets	-5.1	1.9	4.5	6.1	4.5	12.3	5.4
UK Long-dated Gilts	-1.5	7.2	11.4	6.4	7.6	6.8	8.4
UK Long-dated Corp. Bonds	-1.3	5.1	11.3	9.2	8.7	6.6	-
UK Over 5 Yrs Index-Linked Gilts	-1.0	5.9	9.9	7.2	8.9	7.6	7.9
High Yield (Global)	-0.3	2.0	6.1	10.1	9.9	9.7	-
Overseas Bonds	-0.7	1.9	-0.2	-2.2	1.4	5.4	5.3
Property *	1.4	5.2	19.1	9.3	12.0	5.8	8.2
Cash	0.0	0.1	0.5	0.7	0.7	2.7	4.2
Commodities £-converted	-3.7	-7.7	-7.9	-1.4	1.1	-1.7	3.5
Hedge Funds original \$ basis *	1.3	2.0	9.2	5.3	5.8	5.9	8.8
Illustrative £-converted version *	3.0	3.0	1.7	4.6	5.4	6.8	8.4
Euro relative to Sterling	-1.7	-2.7	-6.8	-3.3	-3.1	1.3	-
US \$ relative to Sterling	2.5	5.5	-0.1	-1.3	-0.3	1.1	-0.1
Japanese Yen relative to Sterling	-3.0	-2.6	-10.6	-12.3	-4.2	1.2	-0.6
Sterling trade weighted	0.6	0.0	5.5	3.4	2.2	-1.3	0.1
Price Inflation (RPI) *	0.4	0.4	2.4	2.9	3.7	3.2	2.9
Price Inflation (CPI) *	0.4	0.2	1.5	2.2	2.9	2.7	2.1
Price Inflation (RPIX) *	0.4	0.4	2.5	2.9	3.7	3.4	2.9
Earnings Inflation **	-1.9	-1.5	0.6	1.1	1.6	2.5	3.2
All Share Capital Growth	-2.9	-1.8	2.6	10.0	6.0	4.5	4.3
Net Dividend Growth	-0.2	0.3	0.5	6.7	6.1	5.1	-
Earnings Growth	0.0	2.8	15.7	-6.0	11.0	5.9	5.5

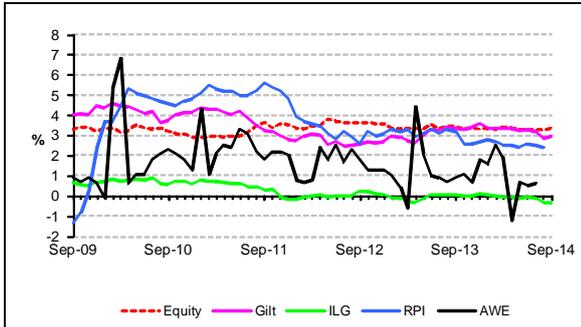
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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.

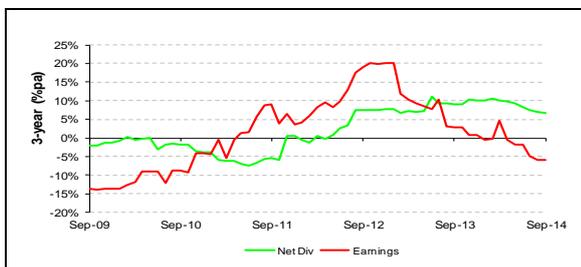
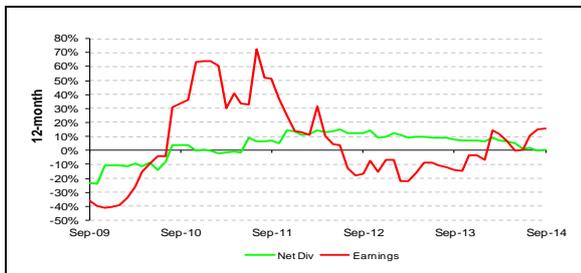


The gap gives a current expectation now around 3.2% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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]

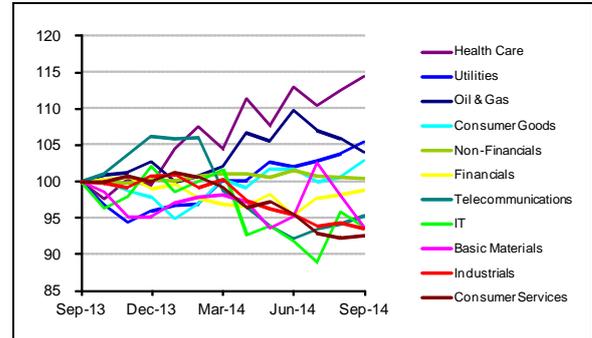
Figure 3: Dividend & Earnings Growth



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



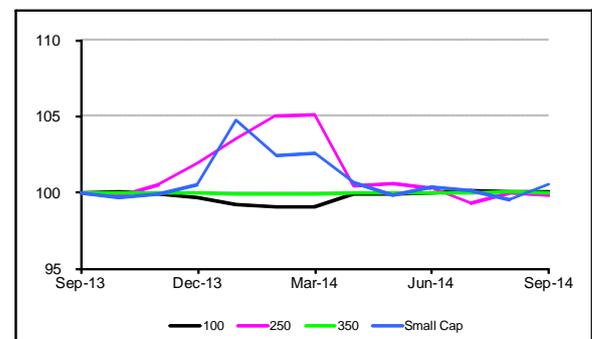
Note: Sector labels for relative lines are in end-value order

There was a slight rise this month in the rolling 12-month sector dispersion (from 20% to 22%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	-4.6	-6.2	10.2
Basic Materials	-7.1	-2.5	-0.6
Industrials	-3.6	-3.0	-0.8
Consumer Goods	-0.6	0.2	9.1
Health Care	-1.1	0.3	21.4
Consumer Services	-2.4	-4.0	-1.8
Telecommunications	-1.6	2.6	1.1
Utilities	-1.3	2.2	11.7
Non-Financials	-3.0	-2.1	6.5
Financials	-2.2	2.7	4.8
IT	-4.9	1.1	-0.6
All Share	-2.8	-1.0	6.1

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



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

FRS17 volatility indicator

Now discontinued, but available on request.



Bond market information

Figure 5: £ Non-Gilt Credit Margins

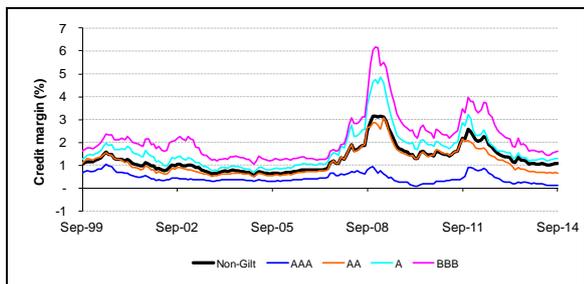


Table 2a: Over 15 Yr Corporate Yields & Margins

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

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

Category	Mkt Val @ Sep 14 & 11, 08			Weight (%)
	Sep 14	Sep 11	08	
Gilts (39)	1,171	902	377	68.1
Non Gilts (1,061)	549	466	407	31.9
AAA (131)	104	128	148	6.1
AA (181)	92	78	70	5.4
A (361)	175	159	127	10.2
BBB (388)	177	101	60	10.3

Category	Mkt Val @ Sep 14, & 11		W't (%)	Dur'n (yrs)
Gilts (39)	1,171	902	68.1	9.8
< 5 Yrs (11)	341	236	19.8	2.7
5-15 Yrs (12)	381	318	22.1	7.1
> 15 Yrs (16)	449	348	26.1	17.4
Non Gilts (1,061)	549	466	31.9	7.9
< 5 Yrs (342)	164	116	9.5	2.6
5-15 Yrs (449)	228	207	13.3	7.6
> 15 Yrs (270)	157	144	9.1	14.0

£ Gilt Market “main” Issuance

- o £4.18bn 2% 2020 (1.59x, 1.94%, new issue)
 - o £1.00bn 4¼ % 2027 (2.15x, 2.65%, Dec 11)
 - o £2.20bn 3½% 2045 (1.99x, 3.17%, Jun 14)
 - o £0.85bn ILG ¼% 2052 (1.96x, r.y -0.20%, May 14)
- Note: Issuance amounts are nominals.

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

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (282)	5,284	59.8
Non Sovereigns	3,545	40.2
AAA (547)	1,049	11.9
AA (470)	804	9.1
A (787)	858	9.7
BBB (815)	833	9.4

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (808)	2,177	24.7
3 – 5 Yrs (706)	1,785	20.2
5 – 7 Yrs (617)	1,526	17.3
7 – 10 Yrs (514)	1,624	18.4
10+ Yrs (256)	1,717	19.4

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Sep 14 & 11)		W't (%)	Dur'n (yrs)
Gilts (24)	437	295	92.6	19.7
< 5 Yrs (2)	44	49	9.2	-
5 – 15 Yrs (7)	132	84	28.1	-
> 15 Yrs (15)	261	163	55.3	28.1
Non Gilts (43)	35	27	7.4	16.9

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

Month End	US (%)	Euro (%)	Sterling (%)
Mar '14	5.40	4.11	5.45
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

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

