



## Investment Update December 2017

### Investment Headlines & Comment

- A remarkably strong month for **UK Equities**, both versus other equity markets and other assets.
- Slight falls in **gilt yields** this month, leading to small positive returns for 2017.
- However, the UK's previously discussed future issuance plans remain a potential issue.

### Feature Section

This month we revisit some aspects of ethical investment, which we looked at earlier this year in our [May 2017](#) issue. The reason for revisiting this so soon is the UK Government's [interim response](#) to the Law Commission's [report on pension funds and social investment](#). In this item, we consider only items relating to trust-based pension schemes (i.e. not any issues associated with personal pensions or contract-based pensions).

The Law Commission's review found that there are no substantive regulatory barriers to making social impact investments. It outlined two tests to be met before Trustees may choose to make a social impact investment that involves some financial sacrifice: first, the Trustees should have good reason to think that scheme members would share the concern, and second, the decision should not involve a risk of significant financial detriment to the fund.

The review concluded that where social investments do not involve a significant sacrifice of competitive risk adjusted returns, most of the barriers are in fact structural and behavioural, such as the need for clearer legislation and guidance on certain issues. The review recommended that for trust-based pensions (e.g. defined benefit schemes), the Occupational Pension Schemes (Investment) Regulations 2005 should be amended to require Trustees to state their policies in relation to:

- (1) evaluating risks to an investment in the long term, including risks relating to sustainability arising from corporate governance or from environmental or social impact; and
- (2) considering and responding to members' ethical and other [*non-financial*] concerns [*where the Trustees have good reason to think members share the concern and it does not involve a risk of significant financial detriment*]. **[Ed.:** this risk is not quantified anywhere!]

The Government has stated that it is not intended that these measures will give any support to campaign groups for boycotts of certain countries or divestment from certain assets. However, activists may feel they have an opportunity, regardless of how well informed they actually are on any particular issue. Some Trustees could be in for headaches, in the same way that some universities have been when students have demanded changes to endowment investment policy. Investment managers are probably going to have to increase their communication materials in this respect, in order to justify the holding of certain investments.

A prime example would be investments in companies perceived as creating climate change risks.

For the converse, investments in companies which are exposed to climate change risks, the Financial Stability Board's Taskforce [report](#) from June 2017 aimed for "consistent, comparable, reliable, clear and efficient climate-related financial disclosures by companies", so there may be more information available for potential investors. However, the process of modelling what effect these disclosures should have on a company's share price or its credit rating seems another matter entirely, particularly if the companies are exposed to other greater risks. Again, this looks likely to be an area where investment managers are probably going to have to increase their communication materials, at least for those where climate change risks are felt to be significant.

Further, a revised policy section on Stewardship would include the Trustees' policy (if any) on the exercise of formal rights (such as voting) and more informal methods of engagement. This particular section is however unlikely to affect Trustees using pooled funds, other than perhaps as part of any manager selection exercise or ongoing monitoring.

The precise wording for these amended Trustee policies is now the subject of consultation, but it seems likely to lead to all existing Statements of Investment Principles (SIPs) needing to be revised.

The Government also believes this may lead to more Trustees being willing to support illiquid infrastructure projects, where the returns occur towards the end of the project, or social projects in the UK (e.g. affordable housing in the area where a sponsoring employer is based), even if the returns are not expected to be quite as high as for other investments which could be made. These investments may be feasible for larger ongoing schemes. However, for paid-up pension schemes looking for ways to reach eventual wind up, neither of these seems a terribly helpful diversification area.



**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 December 2017**

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	<b>4.8</b>	5.0	13.1	10.1	10.3	6.3	6.3
Overseas Equities	1.6	5.1	14.0	15.8	16.1	9.8	8.1
US Equities	1.2	5.7	11.5	16.7	<b>20.1</b>	<b>12.8</b>	7.5
Europe ex UK Equities	0.6	0.5	16.9	14.3	12.8	5.8	8.3
Japan Equities	0.9	<b>7.9</b>	14.4	<b>18.2</b>	16.2	7.8	5.5
Pacific ex Japan Equities	3.5	7.5	23.4	15.3	11.3	8.2	<b>10.0</b>
Emerging Markets	3.7	6.6	<b>25.8</b>	14.8	8.6	6.0	9.5
UK Long-dated Gilts	2.5	3.6	3.3	7.0	7.8	8.3	7.5
UK Long-dated Corp. Bonds	2.5	3.0	5.9	7.4	8.0	8.1	7.6
UK Over 5 Yrs Index-Linked Gilts	2.2	3.9	2.5	8.9	9.5	8.8	8.0
High Yield (Global)	0.4	<b>-0.1</b>	0.7	11.8	9.5	12.1	7.9
Overseas Bonds	0.1	0.0	<b>-2.7</b>	7.0	4.0	7.1	5.6
Property *	1.0	3.0	11.0	9.2	11.3	5.0	8.7
Cash	<b>0.0</b>	0.1	0.4	<b>0.5</b>	<b>0.5</b>	<b>1.2</b>	<b>3.2</b>
Commodities £-converted	4.5	9.0	<b>-3.4</b>	<b>-3.0</b>	<b>-8.9</b>	<b>-6.7</b>	0.1
Hedge Funds original \$ basis *	0.5	2.3	8.6	3.8	5.0	3.2	6.5
Illustrative £-converted version *	<b>-1.4</b>	<b>-2.7</b>	0.3	9.0	8.7	7.6	7.7
Euro relative to Sterling	0.8	0.7	4.0	4.6	1.8	1.9	-
US \$ relative to Sterling	0.1	<b>-0.8</b>	<b>-8.7</b>	4.8	3.7	3.9	1.0
Japanese Yen relative to Sterling	<b>-0.6</b>	<b>-0.9</b>	<b>-5.4</b>	7.1	<b>-1.6</b>	3.9	1.7
Sterling trade weighted	<b>-0.8</b>	<b>-0.2</b>	1.4	<b>-3.8</b>	<b>-1.3</b>	<b>-2.3</b>	<b>-1.2</b>
Price Inflation (RPI) *	0.2	0.4	3.9	2.4	2.3	2.8	2.8
Price Inflation (CPI) *	0.4	0.8	3.2	1.5	1.5	2.4	2.0
Price Inflation (RPIX) *	0.1	0.4	4.0	2.5	2.4	3.2	2.8
Earnings Inflation **	<b>-0.3</b>	<b>-0.7</b>	2.4	2.4	2.1	2.0	3.1
All Share Capital Growth	4.7	4.2	9.0	6.1	6.4	2.5	2.8
Dividend Growth	1.3	1.7	12.8	8.4	6.5	4.3	4.4
Earnings Growth	1.9	19.9	55.5	<b>-3.7</b>	<b>-4.5</b>	<b>-3.0</b>	2.4

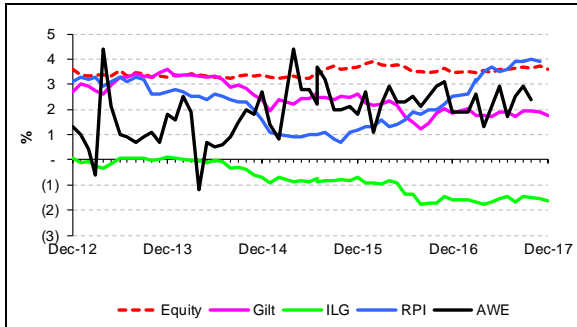
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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 – MSCI IPD UK Monthly Property 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.

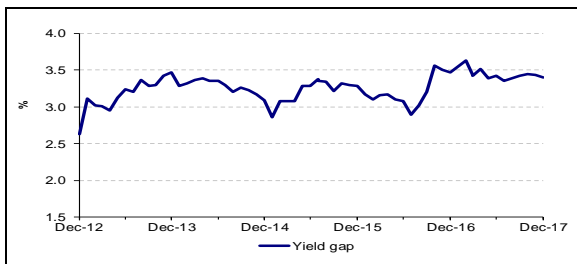


## Yields and Yield Gaps

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.

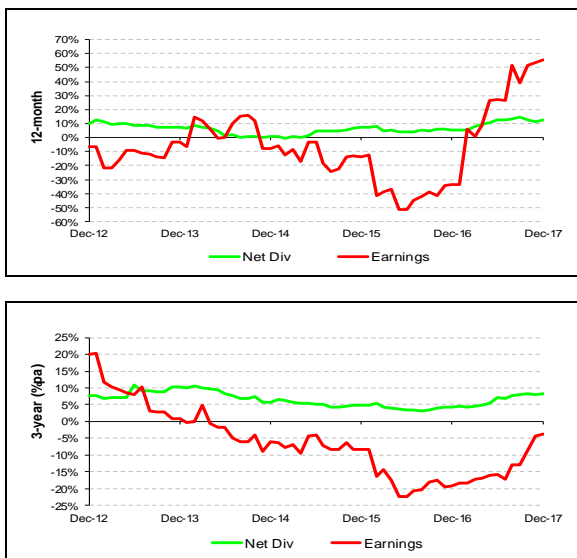


The gap gives a current expectation around 3.4% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

## 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]

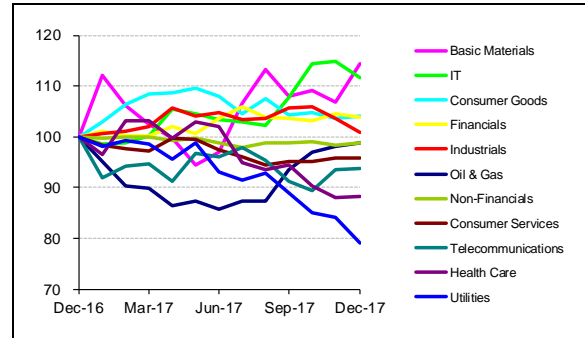
Figure 3: Dividend & Earnings Growth



Note: Earnings data from mid 2015 onwards is under review by FTSE Russell as one-off events may be affecting the prospective P/E ratios

## UK Equity Sector Returns

Figure 4a: Sectors relative to All Share



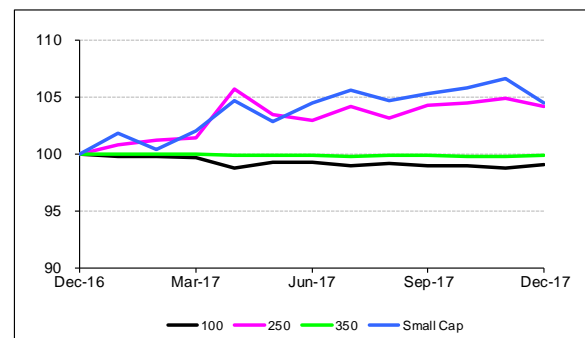
Note: Sector labels for relative lines are in end-value order

There was a rise this month in the rolling 12-month sector dispersion (from 28% to 35%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	5.6	11.0	11.8
Basic Materials	12.1	11.1	29.3
Industrials	2.0	0.2	14.1
Consumer Goods	5.2	4.7	17.6
Health Care	5.1	-1.9	-0.2
Consumer Services	4.9	5.9	8.5
Telecommunications	4.9	7.9	5.9
Utilities	-1.5	-6.7	-10.5
Non-Financials	5.1	4.8	11.6
Financials	4.0	5.3	17.4
IT	2.0	8.9	26.3
All Share	4.8	5.0	13.1

## UK Equity Size Returns

Figure 4b: Size groups relative to All Share



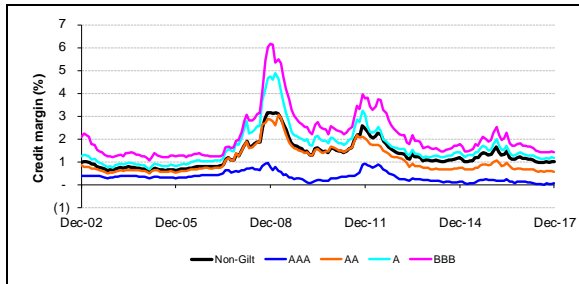
Mid Cap and Small Cap fell in relative terms this month.

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



**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 (%)
Jul '17	2.53	1.88	0.65
Aug '17	2.38	1.72	0.66
Sep '17	2.62	1.94	0.68
Oct '17	2.62	1.93	0.69
Nov '17	2.64	1.89	0.75
Dec '17	<b>2.42</b>	<b>1.77</b>	<b>0.65</b>

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

Category	Mkt Val @ Dec 17 & 14, 11			Weight (%)
	Dec 17	Dec 14	Dec 11	
Gilts (41)	1,362	1,226	999	70.0
Non Gilts (1,066)	584	560	472	30.0
AAA (137)	113	106	129	5.8
AA (160)	83	94	68	4.3
A (340)	170	181	168	8.7
BBB (429)	217	178	107	11.2

Category	Mkt Val @ Dec 17 & 14		W't (%)	Dur'n (yrs)
Gilts (41)	1,362	1,226	70.0	11.7
< 5 Yrs (12)	403	338	20.7	2.8
5-15 Yrs (11)	360	383	18.5	8.2
> 15 Yrs (18)	599	505	30.8	19.9
Non Gilts (1,066)	584	560	30.0	8.1
< 5 Yrs (380)	190	159	9.8	2.8
5-15 Yrs (453)	240	239	12.4	7.7
> 15 Yrs (233)	153	162	7.9	15.4

**£ Gilt Market “main” Issuance**

- £2.75bn ¾% 2023 (2.10x, 0.89%, 0%, Nov 17)
- £2.28bn 1½% 2047 (1.65x, 1.81%, 1%, Sep 17)
- £0.80bn 1/8% IL 2036 (2.34x, ry -1.65%, 0%, Sep 17)

Note: Issuance amounts are nominals. The first % figure in each row is the yield or real yield. The second % figure is the additional amount taken up under the Post Auction Option Facility (PAOF), as a % of the amount of the issue. PAOF does not apply for syndication cases.

**Tables 2d, 2e: € Market Size and Maturity (Dec 17)**

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (347)	6,000	59.3
Non Sovereigns	4,116	40.7
AAA (814)	1,171	11.6
AA (637)	1,009	10.0
A (906)	881	8.7
BBB (1,217)	1,055	10.4

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (895)	2,293	22.7
3 – 5 Yrs (1,009)	2,130	21.1
5 – 7 Yrs (825)	1,664	16.4
7 – 10 Yrs (764)	1,866	18.4
10+ Yrs (428)	2,163	21.4

**Table 2f: Breakdown of £ Index-Linked Market**

Category (Number of issues)	Mkt Val (£bn @ Dec 17 & 14)		W't (%)	Dur'n (yrs)
Gilts (28)	656	478	100.0	23.0
< 5 Yrs (3)	59	52	9.0	3.3
5 – 15 Yrs (7)	152	130	23.1	9.5
> 15 Yrs (18)	445	295	67.9	30.2

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

Month End	US (%)	Euro (%)	Sterling (%)
Jul '17	5.21	2.97	5.35
Aug '17	5.28	3.00	5.33
Sep '17	5.21	2.92	5.25
Oct '17	5.22	2.73	5.15
Nov '17	5.39	2.88	5.37
Dec '17	<b>5.45</b>	<b>2.95</b>	<b>5.40</b>

Sources: DMO, FTSE, iBoxx, J&A, MLX

