



Investment Update February 2017

Investment Headlines & Comment

- LDI hunger for Index-Linked Gilts causes a major fall in the [discount rate for compensation cases](#).
- No sign of that hunger abating either – £11.9bn of demand for £2bn of the **2065 ILG** this month.
- Meanwhile, S&P have updated their [profile](#) of the trillions of **Global Sovereign borrowing**.

Feature Section

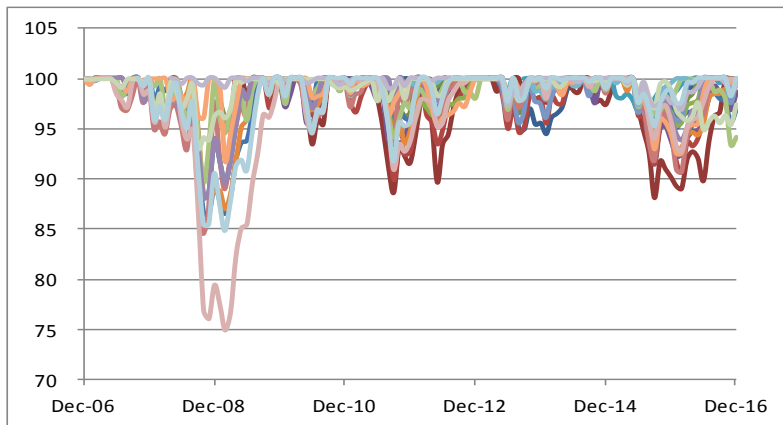
This month we consider the drawdowns experienced by various Absolute Return managers, and the length of time they have needed to recover. We last looked at Absolute Return funds in our [July 2013](#) edition, where the focus was on the dispersion of their returns (and that statistic remains wide, at over 4.5% p.a. between best and worst in a peer group of 15 funds for the 5 years to 31 December 2016, so diversifying across providers remains a sensible approach).

The reason for looking at drawdown is the way that some investors may be using these funds as a substitute for bond funds (given the low redemption yields involved there) whilst making periodic (or regular) withdrawals to finance lump sum payments (or pensions). It's a good idea to look at when a drawdown period starts, how deep it gets, and when it ends. Things are complicated by the fact that not all the funds were running during the "credit crunch", so it's a good idea to look not just at the worst drawdown case for each fund, but also at other less severe instances.

The two versions of Figure 1 below show the drawdowns that have arisen so far, with the second chart excluding the "credit crunch". Each (anonymised) manager is rescaled to have a unit price of 100 at all times since fund launch other than in their drawdown periods. That way, we can see which events affect blocks of managers, e.g. a Eurozone-related

panic, and we can also get a feel for the scales of drawdowns involved.

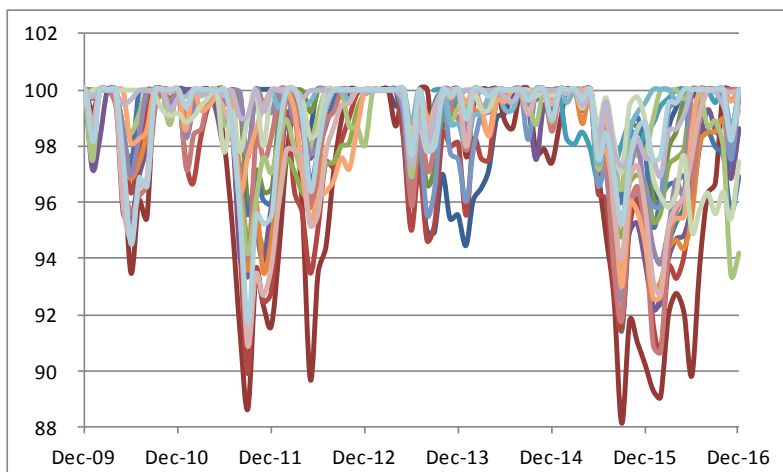
Figure 1a: Drawdowns over the last 10 years



From Figure 1a, most managers experienced "credit crunch" drawdowns in the range of 5%-15%, but it shows there was one clear outlier who took a 25% hit, although that loss was recovered pretty quickly.

Figure 1b shows that in more recent times, the cumulative drawdowns have tended to be in the range of 5%-10%. Those that started in the Spring of 2011 tended to run for around 18 months, whereas those that started in the Spring of 2013 or in June 2015 tended to be shorter, running for around 12 months.

Figure 1b: Drawdowns over the last 7 years



However, there are at least four managers with 2015 drawdown start points where the recovery from that drawdown is *still* going on, although to be fair, the remaining losses are modest.

Finally, the 2015 drawdowns saw 7 consecutive months where all the managers were in some form of drawdown period, so whilst manager diversification may be good to reduce dispersion, there will still be periods where some losses are seemingly inevitable.



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 28 February 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	3.1	7.9	22.8	6.3	9.2	5.9	6.6
Overseas Equities	4.1	8.6	38.7	17.4	15.0	10.0	8.2
US Equities	5.1	8.6	40.5	21.9	19.8	12.7	7.8
Europe ex UK Equities	1.9	9.8	28.2	8.3	11.2	6.0	9.2
Japan Equities	2.5	6.7	36.2	17.8	13.4	5.6	3.9
Pacific ex Japan Equities	4.7	8.9	44.6	14.8	9.3	10.2	6.9
Emerging Markets	4.2	9.5	45.5	12.3	5.1	8.0	7.3
UK Long-dated Gilts	5.1	5.1	11.8	13.8	8.6	8.4	8.3
UK Long-dated Corp. Bonds	4.1	5.5	19.6	11.2	9.4	7.5	-
UK Over 5 Yrs Index-Linked Gilts	1.2	5.0	22.4	15.0	9.7	9.5	8.5
High Yield (Global)	2.3	5.3	34.2	14.1	11.8	12.2	-
Overseas Bonds	1.4	0.9	10.7	9.8	4.5	8.3	5.9
Property *	0.7	2.7	2.7	11.6	9.7	3.9	8.9
Cash	0.0	0.1	0.5	0.5	0.6	1.7	3.5
Commodities £-converted	1.3	3.9	32.6	-13.5	-10.4	-4.1	-0.2
Hedge Funds original \$ basis *	1.2	3.1	9.6	3.0	4.2	3.4	6.8
Illustrative £-converted version *	-0.6	0.0	23.6	12.6	9.0	8.1	8.1
Euro relative to Sterling	-0.6	0.6	9.5	1.2	0.4	2.4	-
US \$ relative to Sterling	1.1	0.4	12.0	10.4	5.1	4.6	1.4
Japanese Yen relative to Sterling	1.7	2.3	13.0	7.1	-1.5	5.2	1.7
Sterling trade weighted	-0.3	-1.0	-8.8	-3.6	-1.0	-3.0	-1.0
Price Inflation (RPI) *	-0.6	0.3	2.6	1.7	2.2	2.8	2.7
Price Inflation (CPI) *	-0.5	0.2	1.9	0.8	1.4	2.3	1.9
Price Inflation (RPIX) *	-0.6	0.3	2.9	1.8	2.3	3.1	2.8
Earnings Inflation **	2.6	2.8	1.7	2.1	1.9	1.9	3.1
All Share Capital Growth	2.5	7.1	18.2	2.5	5.4	2.1	3.2
Net Dividend Growth	2.2	2.4	5.4	4.3	6.6	4.2	-
Earnings Growth	8.3	9.3	6.3	-18.4	-13.4	-5.3	0.9

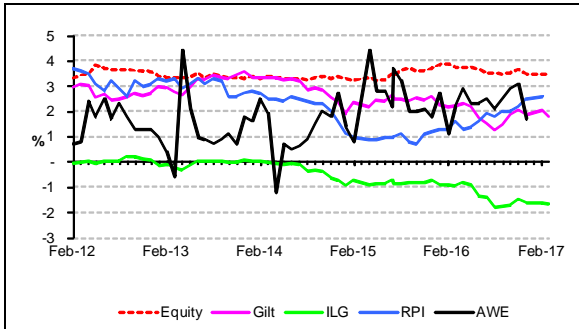
Note: All market returns are total returns for pension funds with income reinvested monthly. Indices used are as follows:

- 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.

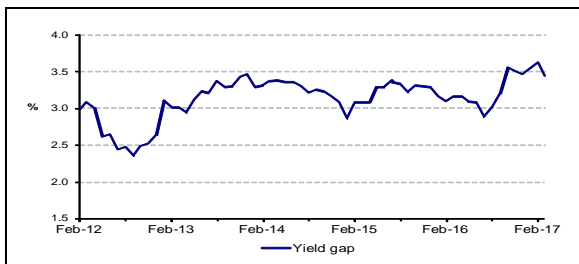


Yields and Yield Gaps

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.

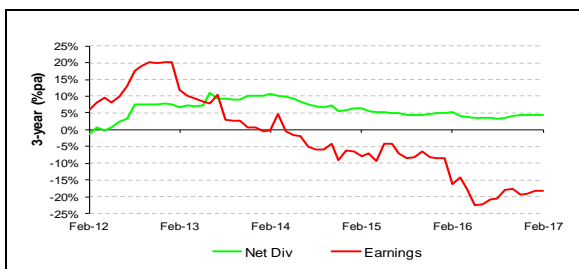
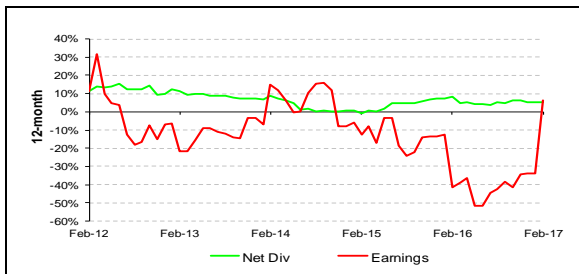


The gap gives a current expectation around 3.4% for longer-term inflation + risk premium for gilts, relative to index-linked gilts.

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]

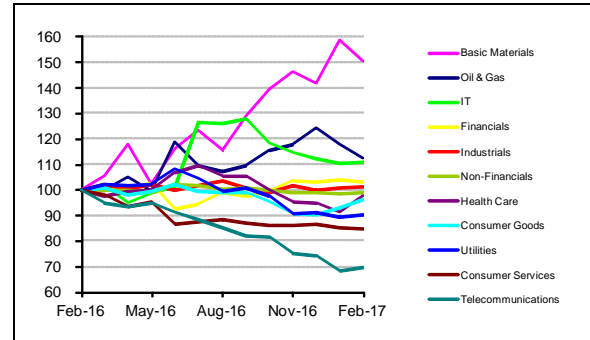
Figure 3: Dividend & Earnings Growth



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



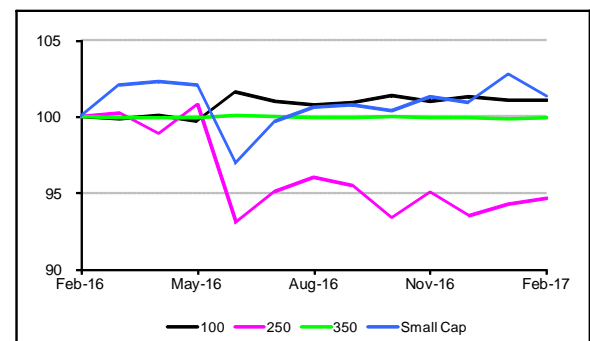
Note: Sector labels for relative lines are in end-value order

There was a marked fall this month in the rolling 12-month sector dispersion (from 124% to 81%).

(% absolute return)	1 mth	3 mth	12 mth
Oil & Gas	-1.9	2.9	37.7
Basic Materials	-2.4	11.0	84.5
Industrials	3.7	7.2	24.3
Consumer Goods	6.7	14.1	18.1
Health Care	10.4	10.6	20.0
Consumer Services	2.5	6.4	4.0
Telecommunications	5.5	0.0	-14.4
Utilities	4.3	7.8	11.1
Non-Financials	3.4	8.1	21.5
Financials	2.2	7.5	26.7
IT	3.2	4.3	36.0
All Share	3.1	7.9	22.8

UK Equity Size Returns

Figure 4b: Size groups relative to All Share



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

FRS17 volatility indicator

Now discontinued, but available on request.

Sources for charts on this page:

Financial Times, Office for National Statistics, J&A



Bond market information

Figure 5: £ Non-Gilt Credit Margins

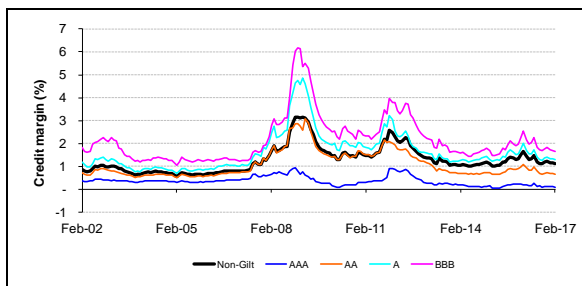


Table 2a: Over 15 Yr Corporate Yields & Margins

Month End	iBoxx Corp AA Y'ld (%)	FT 20 yr Gilt (%)	Margin (%)
Sep '16	2.21	1.46	0.75
Oct '16	2.63	1.85	0.78
Nov '16	2.82	2.03	0.79
Dec '16	2.60	1.86	0.74
Jan '17	2.77	2.03	0.74
Feb '17	2.50	1.77	0.73

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

Category	Mkt Val @ Feb 17 & 14, 11			Weight (%)
	Feb 17	Feb 14	Feb 11	
Gilts (41)	1,376	1,068	812	71.2
Non Gilts (1,007)	556	523	457	28.8
AAA (131)	107	100	125	5.6
AA (165)	87	86	72	4.5
A (334)	169	169	162	8.7
BBB (377)	192	168	98	9.9

Category	Mkt Val @ Feb 17 & 14		W't (%)	Dur'n (yrs)
Gilts (41)	1,376	1,068	71.2	11.6
< 5 Yrs (11)	378	270	19.6	2.7
5-15 Yrs (11)	375	403	19.4	7.5
> 15 Yrs (19)	623	395	32.2	19.4
Non Gilts (1,007)	556	523	28.8	8.3
< 5 Yrs (328)	156	148	8.1	2.8
5-15 Yrs (450)	242	223	12.5	7.5
> 15 Yrs (229)	157	152	8.1	15.1

£ Gilt Market “main” Issuance

- o £3.00bn 1¾% 2019 (2.21x, 0.17%, Jul 14)
- o £2.30bn 1½% 2026 (2.34x, 1.18%, Jan 17)
- o £2.62bn 1½% 2047 (1.63x, 1.86%, Dec 16)
- o £1.25bn 1/8% IL 2026 (1.88x, ry -1.87%, Nov 16)
- o £2.00bn 1/8% IL 2065 (**5.95x**, ry -1.52%, Jul 16)

Note: Issuance amounts are nominals.

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

Category	Mkt Val (€bn)	Weight (%)
Sovereigns (335)	5,844	60.1
Non Sovereigns	3,877	39.9
AAA (740)	1,119	11.5
AA (620)	994	10.2
A (825)	814	8.4
BBB (1,084)	950	9.8

Category	Mkt Val (€bn)	Weight (%)
1 – 3 Yrs (782)	2,102	21.6
3 – 5 Yrs (941)	2,109	21.7
5 – 7 Yrs (782)	1,628	16.7
7 – 10 Yrs (708)	1,806	18.6
10+ Yrs (391)	2,076	21.4

Table 2f: Breakdown of £ Index-Linked Market

Category (Number of issues)	Mkt Val (£bn @ Feb 17 & 14)		W't (%)	Dur'n (yrs)
Gilts (27)	631	387	94.0	23.7
< 5 Yrs (2)	34	44	5.1	-
5 – 15 Yrs (7)	148	106	22.1	-
> 15 Yrs (18)	448	237	66.8	30.2
Non Gilts (36)	40	32	6.0	17.1

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

Month End	US (%)	Euro (%)	Sterling (%)
Sep '16	5.63	3.57	5.97
Oct '16	5.70	3.43	6.09
Nov '16	5.84	3.77	6.04
Dec '16	5.61	3.45	5.80
Jan '17	5.49	3.39	5.75
Feb '17	5.32	3.30	5.52

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

