

BBS factsheet

INTRODUCTION TO EQUITIES

1. WHAT IS AN EQUITY?

An ordinary share, or equity, is a share in the ownership of a company. The shareholders have the right to the income and capital of the company's business after it has satisfied any obligations to the taxman, banks and bond investors.

Shareholders usually have voting rights which allow them to influence the direction and management of the company. These voting rights can be exercised at the company's Annual General Meeting (AGM) when the Board of Directors often require shareholders to ratify proposals.

Most companies have a limited liability, so that in the event of the company becoming insolvent, shareholders are not liable to the creditors beyond their original investment in the company. However, in the event of company insolvency, shareholders rank behind other investors. Because shareholders rank behind bond investors, the shareholder expects a higher return over the longer-term to compensate for the extra risk of their investment.

Unlike bond investments, equities do not have a fixed redemption date and an investor can continue to invest in a particular company until they choose to sell their shareholding, or there is an unexpected corporate event such as the purchase of the entire company shareholding by another company in the event of a takeover or merger.

Larger companies have their shares listed on a major stock exchange, such as the London Stock Exchange in the UK. This enables investors to buy and sell shares more easily and also ensures that investors are provided with appropriate information to allow them to make informed choices as to whether to buy or sell the company's shares.

One other form of share is a preference share, which pays a fixed dividend, the amount of which does not change over time. The company usually has the right to withhold payment of this dividend if finances do not permit. Preference shareholders do not normally carry voting rights, and usually rank above ordinary shares in the event of company insolvency.

2. DIVIDENDS AND SHARE PRICE

In return for their investment, equity investors expect to receive a share in the profits of the companies that they own in the form of dividend payments. Dividend payments are the portion of the company's profits paid to shareholders after meeting all other obligations, such as bank loans, taxation and any payments due to bond investors.

In theory, the dividend paid to investors should increase year on year to reflect the general growth in the economy, corporate earnings and the company's profitability.



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However, dividends are not guaranteed and there are occasions where a company may decide not to declare a dividend, because they have made a loss or because they would prefer to reinvest profits within the business in the hope of making larger profits in the future.

An investor will also expect the company's share price to grow over time. The share price can be considered as the market's average view of what a company is worth. Share prices therefore reflect the market's view of the company's future prospects.

The return from a share is therefore made up from both the dividends paid by the company and the change in the share price over the time that the investor holds the share.

3. WHAT DETERMINES THE PRICE OF EQUITIES?

The market price of equities will depend on the views of investors as they react to

- **Company-specific factors**, both good and bad. A company might announce good news, such as a new contract, better than expected profit figures or a popular key appointment. Bad news might include a cost overrun, lower than expected profits or, for example, the bad publicity arising from the loss of client data records. During late 2007 and 2008, the share price of leading banks collapsed as investors responded to the global credit crunch and fears that banks could go under.
- **Economic factors**. The outlook for the economy which might include increases to interest rates and the corresponding impact on, for example, the house building industry, and banks that have lent to borrowers who are now unable to repay loans. At times when the economy slows, investors may turn to more defensive stocks and sectors such as utility or supermarket shares.
- **Political factors**. This could include reaction to events such as the terrorist attacks on New York in September 2001.
- **Sentiment**. Investors tend to be irrational and react unpredictably. An example of this was the technology stock bubble in the late 1990's when investors wanted to be part of the growth in the internet, and the potential impact on all areas of society. Many investors were prepared to pay hugely inflated prices for companies that were still in the first stage of development and were unlikely to generate profits for some considerable period.



4. UK EQUITY MARKET

The UK equity market is based around the London Stock Exchange (LSE), a capital market which has its origins in the City of London in locations such as coffee houses. In the 19th century, the Stock Exchange developed a set of rules and procedures to enable investors to more easily buy and sell shares and reduce the risk of fraud.

Companies wishing to be listed have to sign an agreement which commits the directors to certain standards of behaviour and reporting to shareholders. The decision to become listed (or go public) is a major step for a company, as it involves huge legal implications and rules and regulations to be observed. However, a listed company is able to access a huge pool of capital from investors such as pension funds, insurance companies, banks, overseas and individual investors.

The FTSE All Share Index is the most representative UK index and reflects the movements of about 600 shares, making up about 98% of the value of the London stock market. The index is further broken down into a number of commercial and industrial sectors so that an investor can measure the performance of a share relative to the market as a whole but also the companies within the same industrial sector.

The main indices in use in the UK market are as follows:

- FTSE 100 Index – the leading 100 companies by market capitalisation, reviewed each quarter. These companies are considered large and relatively safe (“blue chip”).
- FTSE 250 Index – the next largest 250 companies by market capitalisation
- FTSE 350 Index – the largest 350 companies, combining the FTSE100 and FTSE250 indices
- FTSE Small Cap Index – this index covers quoted companies which are not big enough for inclusion in the 100 and 250 indices
- FTSE All-Share Index – this index is the most representative, covering about 98% of the UK market by market capitalisation

At the end of December 2009, the UK equity market was the 2nd largest global stock market by market capitalisation and the market capitalisation of the companies listed on the All Share Index was about £1,620,078 million.

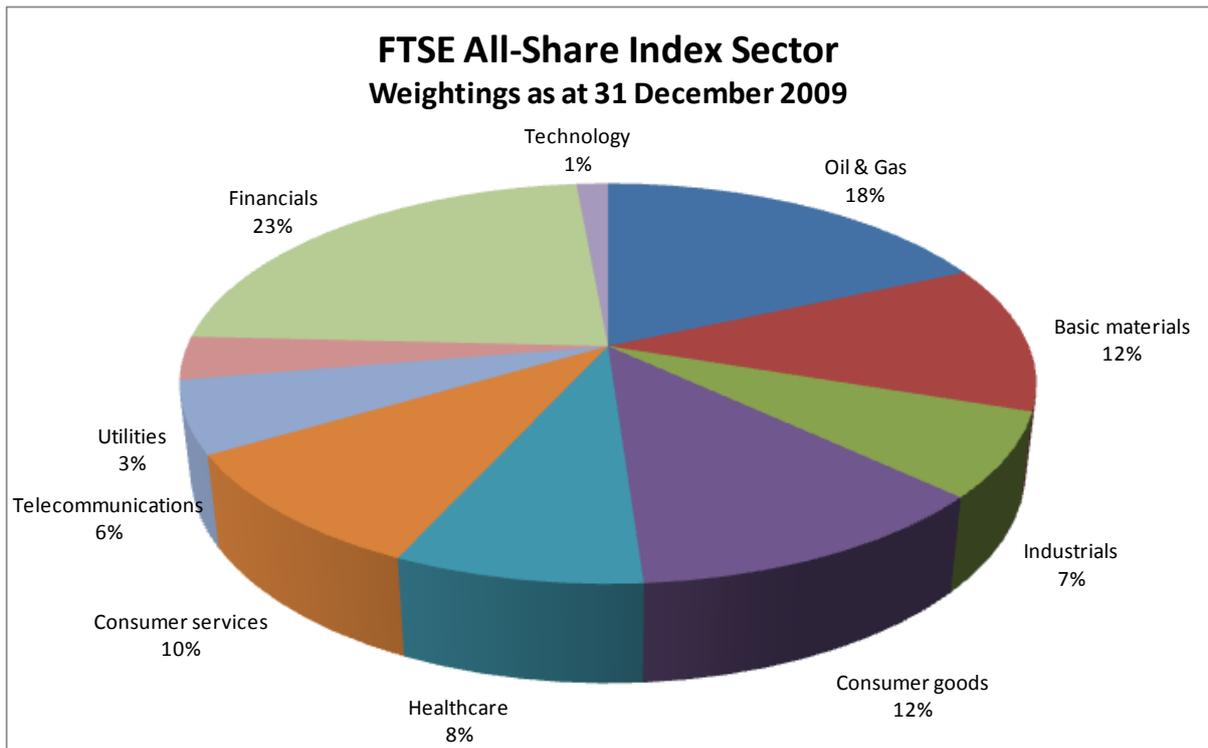
Index	Net Mkt Cap (£million)	Weight (%)
FTSE 100	1,395,209	86.12
FTSE 250	189,915	11.72
FTSE Small Cap	34,954	2.16
FTSE All Share	1,620,078	100.00



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The FTSE All Share Index is dominated by a small number of stocks and sectors. At 31 December 2009, the top 10 stocks comprised around 40% of the Index and the top 20 stocks about 60% of the Index. This means that the fortunes of one stock or sector can have a significant impact on the overall daily movements in the UK equity index.

As at 31 December 2009, the sector mix of the FTSE All Share Index was as follows:



Source: FTSE

CHARACTERISTICS AND KEY FACTORS

Expected Return: equities have, historically, provided a higher level of return than other asset classes over the long-term, and growth has been ahead of earnings and price inflation. This makes them suitable for investors such as pension schemes, with liabilities linked to earnings and inflation, and where the time horizon for the investment strategy may be 50 years or more. However, it is impossible to predict the level of future equity returns and direction of equity markets with any certainty.

Income: most companies pay an interim dividend each half-year and a final dividend once the company report and accounts have been finalised. Equity dividends are expected to grow in line with corporate profitability and growth in the economy as a whole. However, the dividend stream is uncertain and companies do not guarantee to pay dividends. The typical dividend yield in the UK equity market is 3% (ie the dividend paid is about 3% of the company's share price).

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Marketability: most quoted shares are reasonably liquid and marketable, although it may be more difficult to find a buyer for smaller company stocks that are traded less frequently. Investors wishing to sell large amounts of a single stock may need to sell down their shareholding in small chunks to avoid having an impact on the share price.

Diversification: it is possible to invest across a wide range of stocks and sectors to gain exposure to a wide portfolio of different companies.

Security: there is the risk that a company may become insolvent in which case equity investors rank after all other creditors. In practice, it is unlikely that an equity investor would receive any of their initial investment in the event of insolvency.

Valuation: the market price of all quoted shares is available immediately, so an investor is always able to determine the value of their investment.

Volatility: share prices can be volatile. It is not unusual for the index to rise or fall by 3%-5% in one day and, on extreme situations, markets can move significantly as investors react to events. For individual shares, prices can move over 20% in a single day in response to business developments.

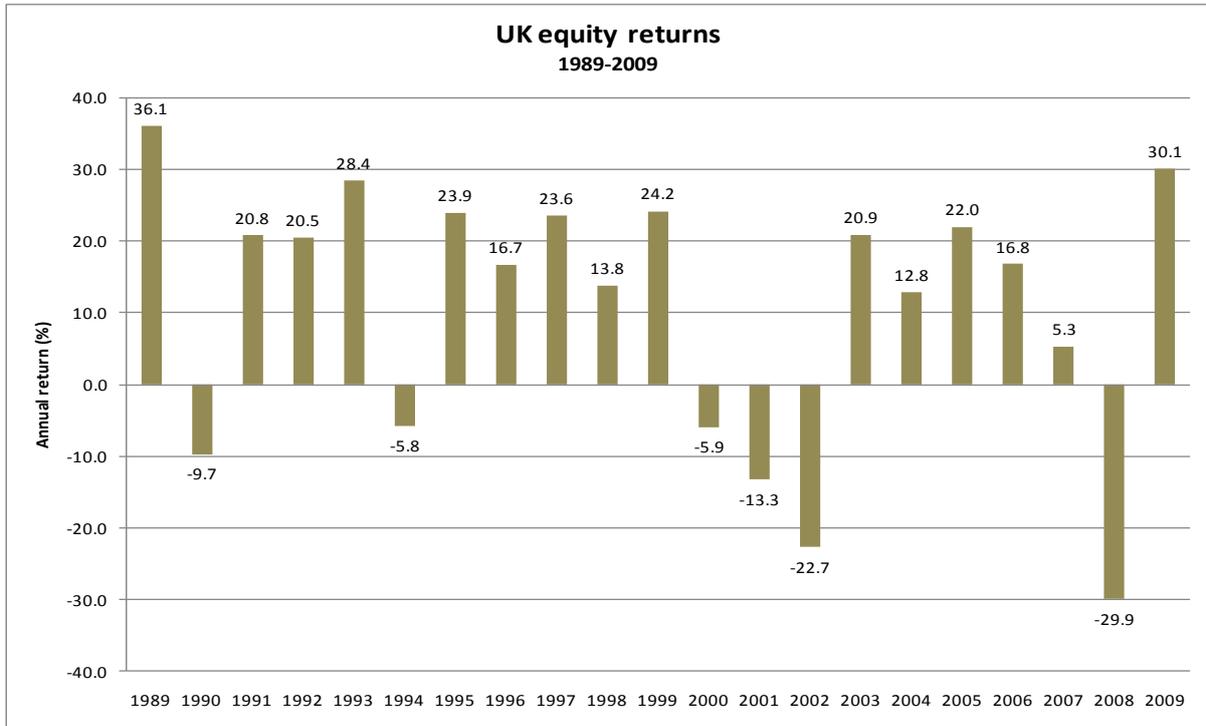
Tax: while all UK dividends have been taxed since 1997, capital gains are free from UK tax. The position for overseas equities will depend on whether the UK has a reciprocal taxation agreement with the country concerned.

Cost: costs are generally low. The typical annual management charge of a UK equity fund might be up to 0.25%-1.0% pa on an active basis, and 0.1% on a passive basis. The charge for an actively managed fund will depend on the level of outperformance required from the manager relative to the benchmark, usually a suitable UK equity index.



HISTORIC RETURNS

The annual returns from the UK equity market, as measured by the FTSE All Share Total Return Index in each year from 1989 to 2009 have been as follows:



Source: FT

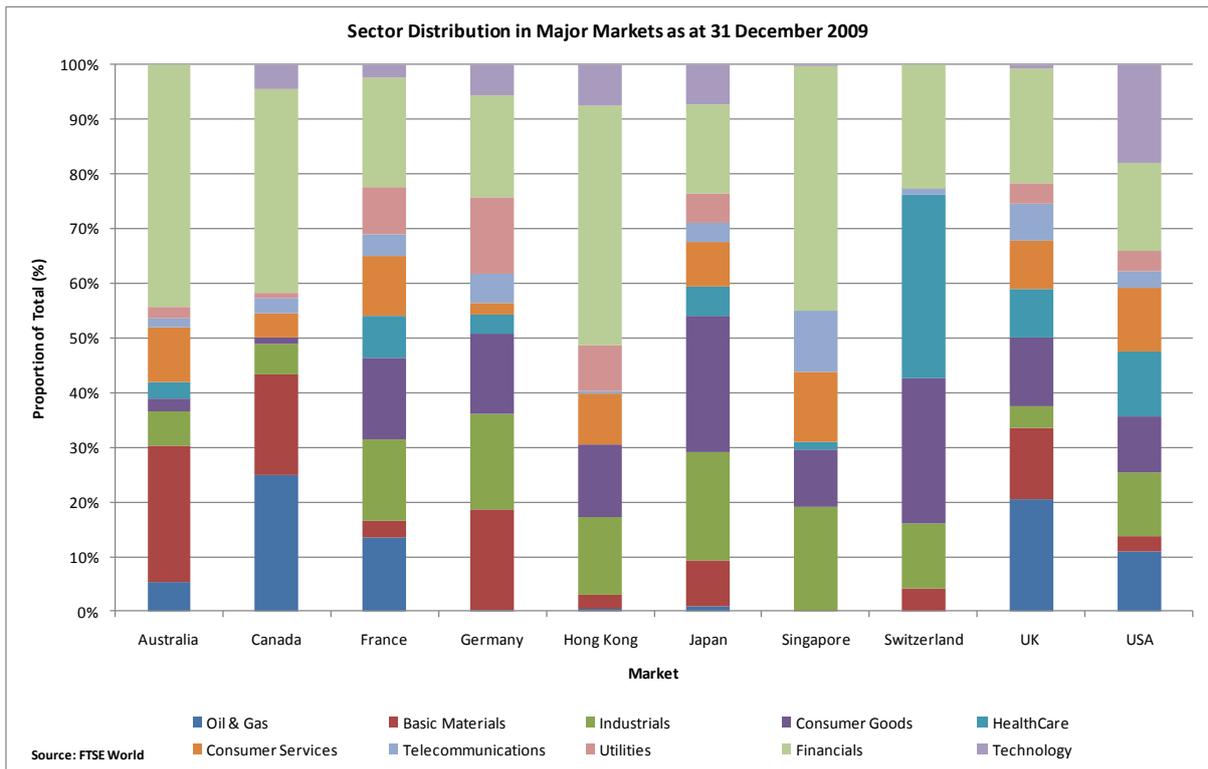
Over the past 10 years, the UK equity market has been particularly volatile. The FTSE100 index of leading shares rose almost 75% between the start of 1997 and the end of 1999 during the technology stock bubble. This tech bubble burst during 2000 and early 2001, and investors were then hit by the events of 9/11 and subsequent corporate scandals, such as Enron, which damaged investor confidence.

The index reached a low in March 2003 just before the Gulf War, and then recovered ground steadily. During late 2007 and 2008, the UK equity market fell significantly as the impact of the global credit crunch led to a global recession. Following unprecedented Government intervention intended to prevent a depression, the market rebounded by 43% from March 2009, leading to a return of 30% for the 2009 calendar year.



5. OVERSEAS EQUITIES

The UK market is highly concentrated to a small number of stocks and sectors. By investing in overseas equity markets, investors can gain exposure to different sectors or industries. For example, the UK index is also considered very defensive as it has very limited exposure to technology stocks by comparison to the US market. On the other hand, the German market has no exposure to Oil & Gas stocks whereas two of the largest stocks in the UK index are BP and RoyalDutch Shell.



Investing overseas was also considered to provide diversification from the UK economy, as other markets might be at different points on the economic cycle. However, the evidence is increasingly towards a global economy and that all economies are increasingly dependent on the fortunes of the American market.

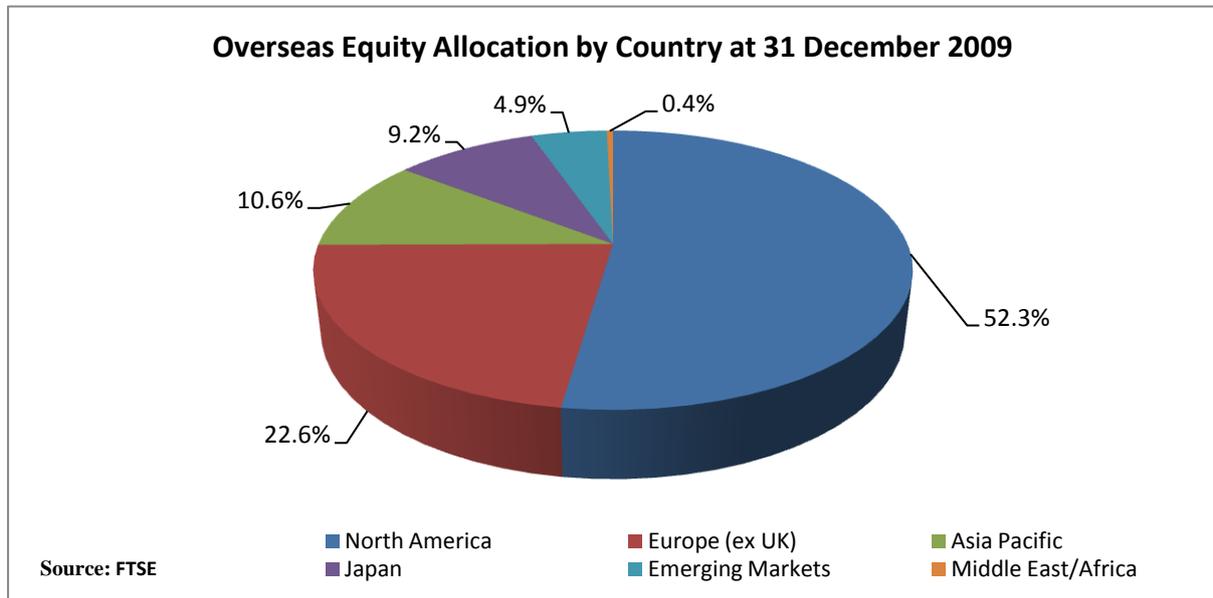
If pension schemes invest overseas, the portfolio will usually be well diversified across the major overseas equity regions. Excluding the Japanese equity market, the main countries which make up each region are broadly as follows:

- North America – US and Canada
- Europe (ex UK) – France, Germany, Switzerland, Spain, Italy, Netherlands
- Asia Pacific (ex Japan) – Australia, Singapore, Korea, New Zealand, Hong Kong
- Emerging Markets – Brazil, China, India, South Africa, Russia, Mexico



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The approximate mix of the global equities by market capitalisation at the end of 2009 was as follows:



Investing overseas introduces risks for investors such as:

Currency risk: the returns from investing in overseas equities will depend not only on the returns from each overseas equity market but also on changes in the value of Sterling relative to the local currency. Some funds and managers will hedge the currency risk so that returns do not depend on currency movements.

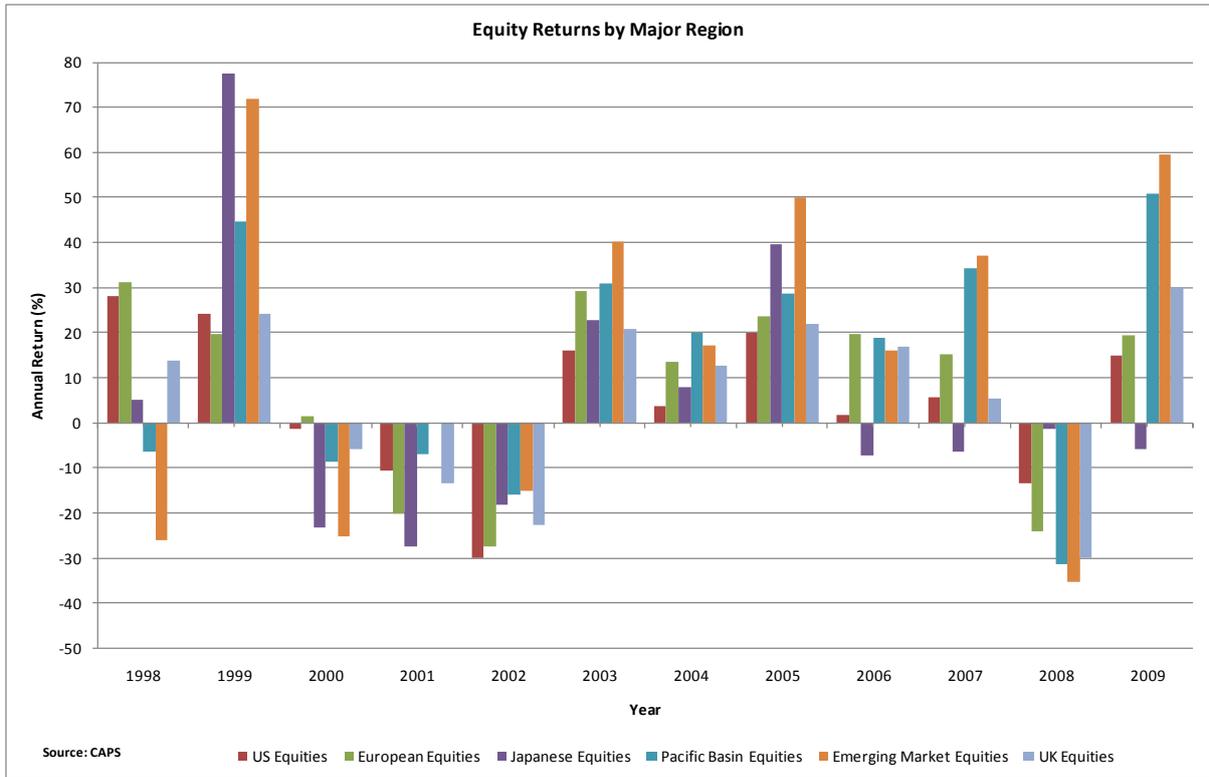
Information: while major equity markets are well regulated and information is available to investors, some less developed markets may not yet provide such access to information to allow investors to take an informed view.

Political risks: investing in less developed equity markets may expose a UK investor to risks such as sudden changes in government, and changes in policy on overseas investors.

Cost: the cost of investing overseas is usually higher than in the UK. The typical annual management charge of an overseas equity fund might be up to 0.5%-2.0% pa on an active basis, and 0.25% on a passive basis, although this will vary for each overseas equity region.

HISTORIC RETURNS

The annual returns in sterling terms from the major regional equity markets each year from 1998 to 2009 have been as follows:



Just like the UK market, overseas markets became overvalued at the end of 1999 and fell dramatically during 2000-2002 until markets rallied after the Gulf War in 2003. In 2008, global equity markets fell sharply driven by the global credit crunch and recession and rebounded in 2009 under the assumption of an economy recovery.

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