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BBS investment update

Quarter to 31 December 2011

SUMMARY OF 2011

At the end of 2010, we suggested that whilst, on the face of it, the odds appeared to be stacked against bonds, and UK government bonds (gilts) in particular, it might only take a couple of bumps in the road for demand to pick up for them given their 'safe haven' attributes. This happened with a vengeance in 2011, with long-dated fixed interest gilts returning over 26% for the year, with their index-linked counterparts not much behind, with a calendar year return of 20%. At the same time developed equity markets have struggled, with all major markets under water for the year, although US dollar appreciation managed to just about haul the Sterling return for the US market into positive territory.

This is a very uncomfortable result for pension schemes, whose liabilities are commonly linked to the price of gilts but who still depend, often to a large extent, on equities to generate investment growth. Gilts are now trading at or around historically high price levels. Whilst it is tempting to suggest that this is a bubble that will burst, current economic uncertainty and the potential for interference and intervention in gilt markets by the Bank of England, the Government and rating agencies make it difficult to foresee what the direction of gilt markets will be in the next few years.

The bumps in the road during the year were multiple and mostly revolved around sovereign debt, i.e. money owed to investors by countries. In particular, Europe and the problem of dealing with its debt burden given its political structure, financial interdependencies and imbalances was the main focus. This issue will rumble on in 2012 and markets will be prone to flare up as attempts to resolve the crisis develop. One optimistic note is that the Long-term Refinancing Operation (LTRO) announced by the European Central Bank in December has been well received by markets on the basis that it is a substantial measure to provide liquidity in the European banking sector for the next few years, materially reducing the risk of a full blown banking crisis.

BBS Consultants & Actuaries Ltd

Canard Court
23-25 St George's Road
Bristol, BS1 5UU

Tel: 0117 937 8700

Fax: 0117 937 8701

Email: info@bbs-actuaries.co.uk

Website: www.bbs-actuaries.co.uk

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SUMMARY OF 2011 (CONTINUED)

The world's largest economy, the US, lost the AAA-rating on its debt as a result of political wrangling about its overdraft limit and the lack of a credible plan to improve its financial position. This, together with increasing nervousness about Europe and concerns about economic growth in developed markets led to a sharp equity sell-off in August from which the markets are still gradually recovering.

On top of the economic problems facing the world, equity returns and global supply lines were also affected by the Japanese earthquake and tsunami in March. Emerging market economic performance also slowed during the year, and their equity markets performed poorly, being affected by both the global economic environment and specific domestic issues.

Despite the huge uncertainties in the global economy, the sounds from the markets in early 2012 appear to be cautiously optimistic. This is primarily based on a belief that the US economy is in a better state than feared, progress is being made on the European problem, and China does not currently appear to be at risk of a large adverse correction in its economy. Whether this is all wishful thinking remains to be seen.

The developed world needs to find a means of reducing its debt burden, but avoid killing off growth. Otherwise, the prospect of static, or contracting, economies looms. Historically, the means of doing this has been to let inflation off the leash, and one might argue that the conditions for this have already been laid. The other tools available to governments are austerity and continued economic stimuli such as ultra-low interest rates and money printing. Whilst there may be some reasons to be cheerful, the outlook remains cloudy.

KEY ECONOMIC INDICATORS AT 31 DECEMBER 2011

	Base Rate	10 Year Bond Yield	CPI Inflation	Exchange Rate (£1)
UK	0.50%	1.98%	4.20%	-
USA	0.25%	1.88%	3.00%	\$1.55
Europe	1.00%	1.83%*	2.70%	€1.20
Japan	0.00%	0.98%	-0.20%	¥119.57

Source: FT; *German Bund

The Bank of England's Monetary Policy Committee (MPC) maintained the UK base rate at 0.5% throughout the quarter. An increase in the Bank's programme of quantitative easing of £75 billion was announced in October, reflecting concerns that the economy was at risk of sliding back into recession. The total amount of money that has been released into the economy using this mechanism since 2008 now totals £275 billion. The MPC's view is that inflation will start to fall during the first part of 2012, due to energy and import prices reducing and the effects of last year's increase in VAT falling out of the calculations and, consequently, in its view, the Bank's attitude towards interest rates and quantitative easing remains justifiable.



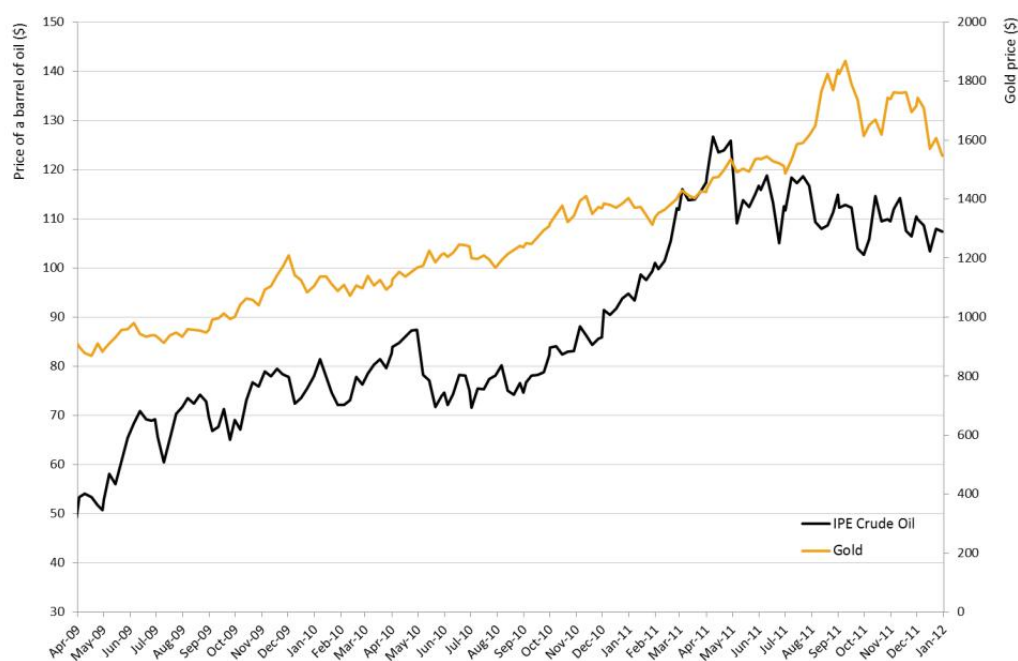
Base rates in other major developed economies remained very low over the quarter, with the European Central Bank (ECB) reversing its decision to increase rates earlier in 2011.

Benchmark government bond yields in the UK and US continued to fall over the quarter as investors sought relative safety from the Eurozone. In particular, yields on 10 year UK gilts fell below 2% towards the end of the quarter, the lowest level recorded.

Inflation fell during the quarter, reflecting weakening demand in many developed economies, with Japan falling back into deflationary territory.

Sterling appreciated against the Euro by around 3% over the quarter, with a slight depreciation against the Dollar and Yen.

GOLD AND OIL PRICES – YEAR TO 31 DECEMBER 2011



Source: FT, IPE Exchange

The price of gold fell over the quarter by 4.25%, although prices remain high given gold’s role as a hedge against the continued risk of currency devaluation. The price of oil was volatile within a reasonable narrow range, with prices increasing by 5% over the quarter to \$107 a barrel.



UK EQUITIES

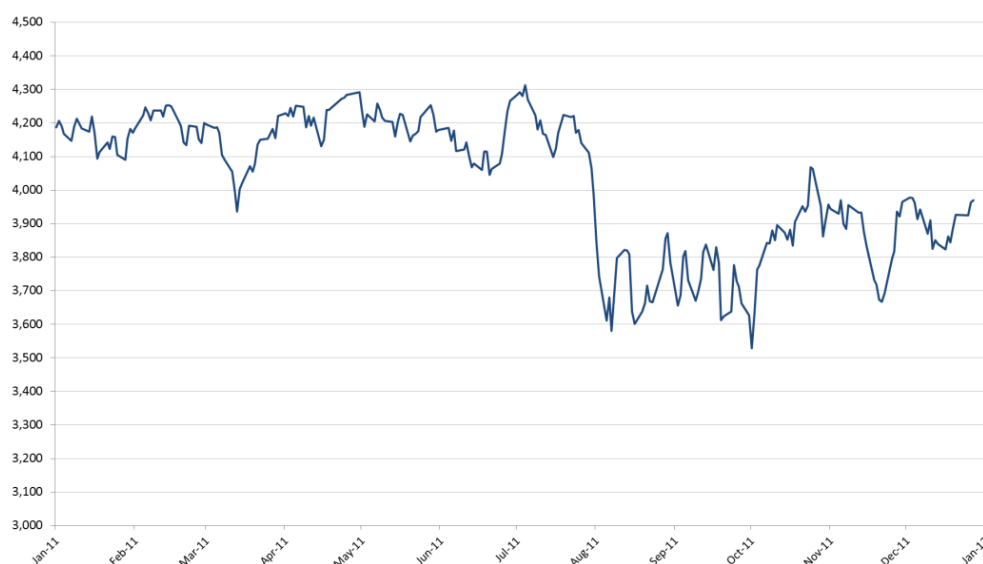
	Q4 2011	1 year	3 years (pa)	5 years (pa)
FTSE100	9.4%	-2.2%	11.9%	1.5%
FTSE250	3.5%	-10.1%	20.0%	0.8%
FTSE Small Cap*	-3.5%	-15.2%	16.1%	-7.9%
FTSE All Share	8.4%	-3.5%	12.9%	1.2%

Source: FTSE; *excludes investment companies

The UK equity market generated a return of 8.4% over the quarter, with large companies generating the strongest performance. Five year returns for UK equities remain disappointing for investors.

The strong headline figures masks some significant volatility, which can be seen in the chart below:

FTSE ALL SHARE (TOTAL RETURN INDEX) – YEAR TO 31 DECEMBER 2011

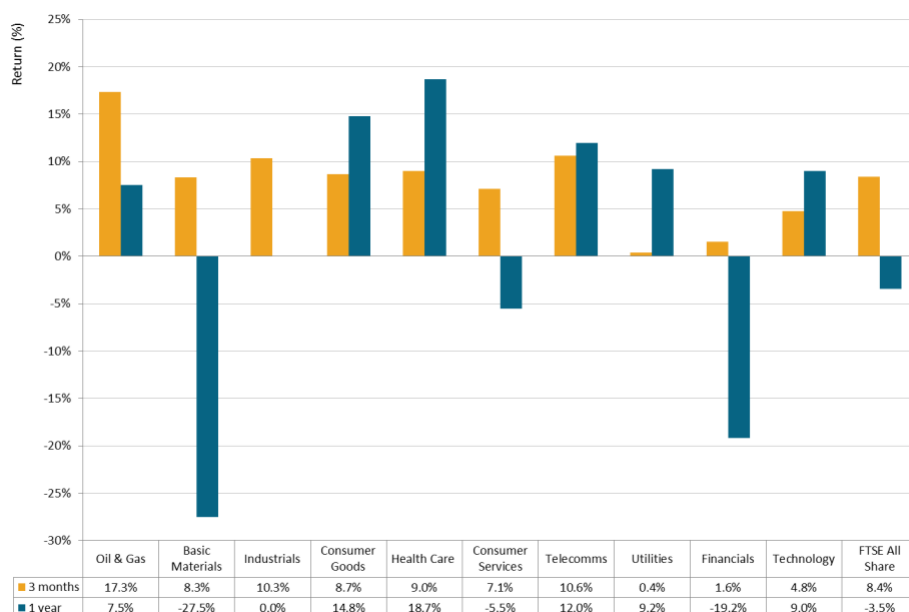


Source: FTSE

All market sectors were in positive territory over the quarter, with defensive utilities and the European-exposed financial sector bringing up the rear. For the year to 31 December 2011, it is notable that returns for financials and the economically sensitive mining and resource companies (basic materials) were particularly weak, dragging the performance of the market negative. The UK market is particularly exposed to these sectors, which still comprised around 30% of the market at the end of the year.



RETURN BY INDUSTRIAL SECTOR – 3 MONTHS AND YEAR TO 31 DECEMBER 2011



Source: FTSE All Share (TRI)

GLOBAL EQUITIES

	Q4 2011	1 year	3 years (pa)	5 years (pa)
FTSE All World (ex-UK)	7.2%	-6.9%	9.5%	3.6%
North America	11.3%	1.2%	11.4%	4.8%
Europe (ex-UK)	3.3%	-15.0%	3.3%	-1.0%
Japan	-3.6%	-12.9%	-0.8%	-2.0%
Dev Asia Pacific (ex Japan)	6.2%	-12.3%	17.9%	8.8%
Emerging markets	4.7%	-17.6%	17.3%	7.6%

Source: FTSE, BNY Mellon Data Analytics; total returns are in Sterling terms

Total Sterling returns (including dividends) for overseas equities were generally favourable over the quarter, although there were some significant differences by geographical region. The best longer term performance has come from the Far East (excluding Japan) and Emerging Market countries.

Most major equity markets posted positive capital growth for the quarter (in local currency terms), with the exception of the Japanese market.

Sterling’s value appreciated against the Euro by some 3%, reducing unhedged returns from Eurozone markets. Sterling lost a little ground against the US Dollar and the Yen over course of the quarter, enhancing US and Japanese market returns in Sterling terms.



The 'busyness' of the graph below is the result of the significant levels of volatility in 2011 and, also, the divergence in returns between different markets.

CHANGE IN VALUE OF OVERSEAS EQUITY MARKETS – YEAR TO 31 DECEMBER 2011



Source: FT; rebased to 100 on 1 January 2011; domestic currency terms

The Indian and Chinese markets fell in value by around 6% over the quarter, whilst the Brazilian market followed a similar pattern to those of developed markets, rising by 8%. Despite continuing economic growth in these countries, their stock markets had a bad year, posting significant losses.

CHANGE IN VALUE OF KEY EMERGING EQUITY MARKETS – YEAR TO 31 DECEMBER 2011



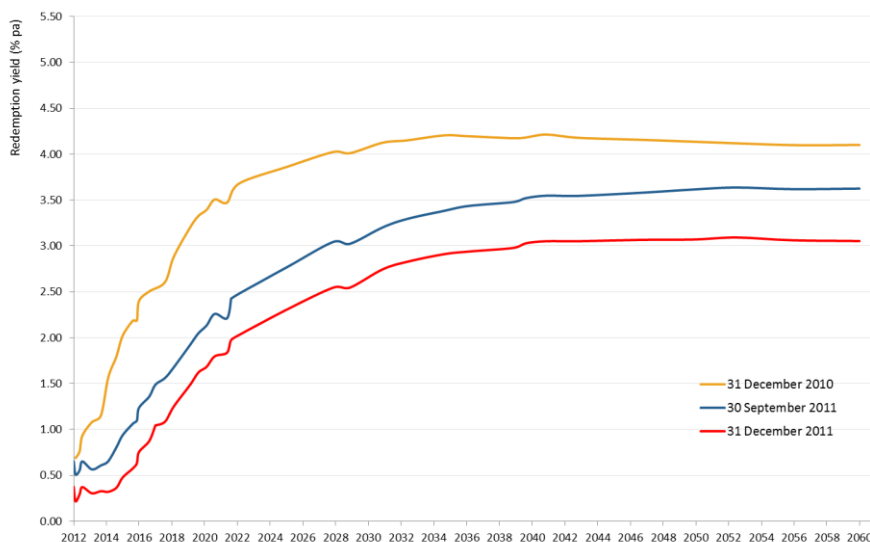
Source: FT; rebased to 100 on 1 January 2011; domestic currency terms



BOND MARKETS

Gilt yields fell uniformly along the yield curve over the quarter, reaching historically low levels. The continuing use of gilts as a safe haven reflects the market’s favourable view of the UK’s financial independence (as we can pay debts by printing money), coupled with the Government’s commitments to tackle our budgetary deficit with austerity measures.

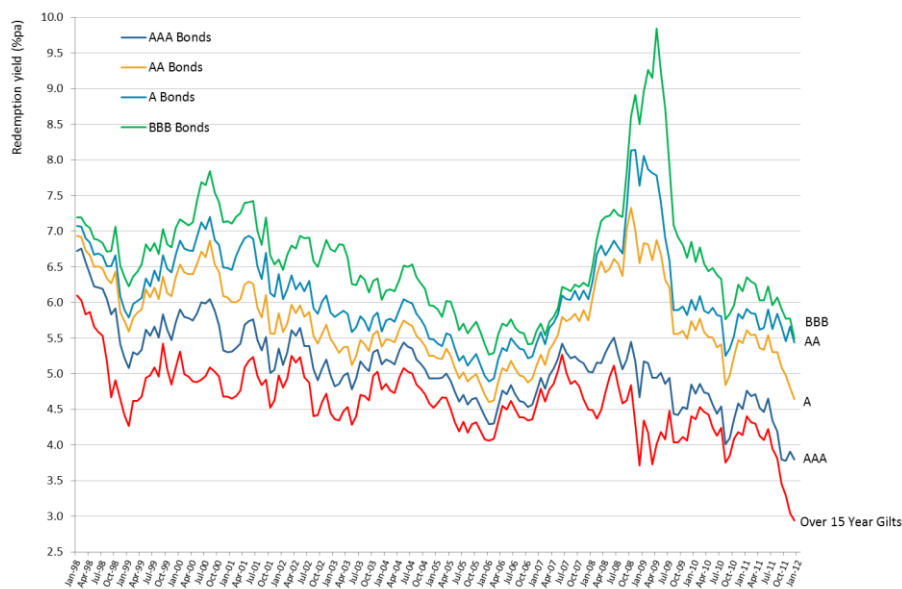
GILT YIELD CURVE – 31 DECEMBER 2011



Source: Debt Management Office

The gap between yields on corporate bonds and gilts widened over the quarter primarily as the result of strong demand for gilts as opposed to weakness in corporate bond markets, in which yields also fell.

OVER 15 YEAR CORPORATE BOND YIELDS VERSUS GILT YIELD – TO 31 DECEMBER 2011



Source: iBoxx, FTSE



A summary of bond returns for periods to 31 December 2011 is given in the table below. Gilts continued to perform strongly in Quarter 4 and the one-year figures are particularly strong. Corporate bonds trailed in the wake of gilts, but still generated reasonable positive returns.

	Q4 2011	1 year	3 years (pa)	5 years (pa)
All Stocks Gilts	5.0%	15.6%	7.0%	7.8%
Long-dated Gilts	9.6%	26.3%	9.3%	8.8%
Index-linked Gilts	8.4%	19.9%	11.6%	9.4%
All Stocks Bonds	2.3%	6.9%	8.7%	4.6%
Long-dated Bonds	3.7%	12.0%	11.4%	5.3%
Overseas Govt Bonds	0.0%	7.4%	2.2%	13.0%

Source: FTSE, iBoxx, JP Morgan

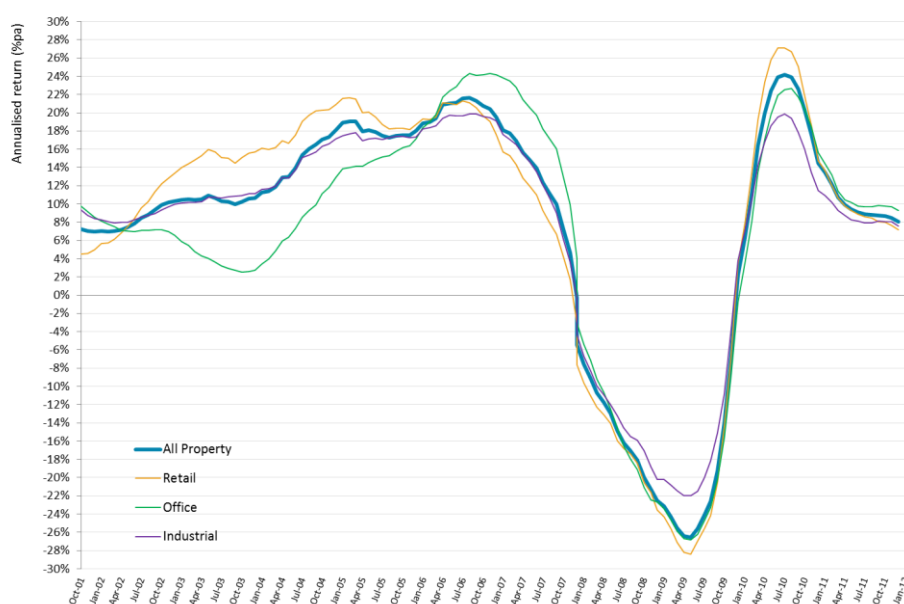
COMMERCIAL PROPERTY

	Q4 2011	1 year	3 years (pa)	5 years (pa)
Retail	1.3%	7.2%	8.3%	-2.1%
Office	1.8%	9.3%	7.9%	-1.2%
Industrial	1.7%	7.6%	7.6%	-1.0%
All commercial	1.6%	8.1%	8.1%	-1.5%

Source: IPD

The commercial property market generated a steady return of 1.6% for the quarter, primarily driven by rental income, although down by 0.3% from the previous quarter. The graph below shows the rolling annual return over the last 10 years.

PROPERTY ROLLING 12-MONTH RETURNS TO 31 DECEMBER 2011



Source: IPD



Residential property prices continued to fall over the quarter, reflecting continuing economic uncertainty.

	Q4 2011	1 year	3 years (pa)	5 years (pa)
Residential	-2.8%	-2.3%	-0.1%	-3.0%

Source: Halifax

Please contact your usual BBS consultant if you have any queries on this update.

Jude Bennett FIA

Investment Consultant

Telephone: 0117 937 8793

E-mail: jude.bennett@bbs-actuaries.co.uk