

**Ian Kernohan**, Economist at RLAM, looks at why the public perception is that the UK is still in recession and what it will take for the feelgood factor to return.

**Robert Talbut**, RLAM's Chief Investment Officer, proposes some changes to corporate remuneration policies which would benefit shareholders and employees alike.

**George Henderson**, Manager of the Royal London Global Index Linked Fund, discusses the effects of rising energy prices on inflation and index-linked bonds.



**Ian Kernohan,**  
*Economist*

Since 2007 the pound has fallen by 25% and interest rates have never been lower. Under normal circumstances, we might have expected such an unprecedented easing in monetary conditions to have produced a repeat of the Barber and Lawson booms, as people scrambled to buy each other's houses with cheap debt. Things haven't quite turned out like that: house prices are falling, albeit gradually, and incomes have stagnated. As Mervyn King would say, it's the source of the shock, rather than the shock per se, which is important when we look at interest rates and sterling. The reason *why* monetary conditions appear to be so loose is because we suffered such a deep recession in the wake of the worst banking crisis in over a century. And no matter what the economic data

suggest, most people in the UK believe we are *still* in recession, and I would expect this situation to continue until the economy is strong enough to engender that elusive feelgood factor.

The benefits of sterling's devaluation appear to be well hidden, while the costs in terms of higher inflation are very evident. Yet beneath all the handwringing there has been a sharp recovery in the UK's manufacturing sector, as companies take advantage of the cheaper currency and the rebound in global trade. However this revival of exports hasn't boosted GDP figures, given that service sector exports have yet to recover and imports have been even stronger. Much of the strength in imports has been driven by short term movements in the stock cycle, rather than strong domestic demand: inventories tend to be import-intensive and as de-stocking ends and stocks are rebuilt, imports respond. This phase of the cycle should now be over and I would expect the import drag on GDP to wane from here, particularly if consumption remains weak.

Despite the silver lining of a revival in manufacturing, output in the sector has only just returned to levels seen in the mid 1990s. This is a measure of the scale of the collapse in 2008/9. The big picture for the UK economy remains an unfortunate mix of stubbornly high inflation and very modest growth rates. Buoyancy in manufacturing will go some way to make up for weakness elsewhere in the economy, although the sector isn't really large enough to underpin a major economic revival in the UK, which will only come about when the household and government balance sheets are in better order.



**Robert Talbut,**  
*CIO*

Far too much of the debate about remuneration takes place in isolation, with little regard for the context of a company and its strategy. This has meant that shareholders have tended to focus almost entirely on the technical aspects of proposals, therefore remaining silent on the issue which most interests the wider public - that of quantum. I would like to make a proposal that I believe will shift this overall debate into a far healthier place, for shareholders, for management and also for society as a whole.

As a first step I believe that we have to move away from the current standardised approach whereby a company proposes a set of targets, such as EPS or total shareholder return that management needs to achieve in order to earn part or all of a long term incentive scheme. The only real change to this has been that schemes have become more complex as numerous targets are introduced, meaning that considerable time is required in order to try to establish potential outcomes. This appears extremely counterproductive because incentives surely work best where they are relatively simple and clearly understood. Currently we appear to be shifting ever further away from this ideal.

My principal recommendation is that all companies should produce a distributions schedule each year. For each company we could therefore see how profits earned by the business have been used, firstly through the amount of investment in the business that has been undertaken; secondly by the amount of dividends that have been paid to shareholders; and lastly by how much was paid to both all staff and to the executive team. The schedule should also set out how these distributions have trended over the previous three

years. Clearly presented, this information would allow for a much higher quality discussion about how these decisions were made and the merits of the various stakeholder claims. The result should be a much improved understanding of how the company's strategy was being implemented, how this was consistent with the risk profile of the business and then what this logically meant for the providers of capital (the shareholders) through the dividend payment and then for the staff (including the executive) through remuneration decisions.

The distribution schedule could over time become a central focus for how shareholders engaged with management and could clearly establish the linkage between strategy, investment, risk and remuneration. It should move much of the somewhat sterile current debate over remuneration into a far better understanding of how remuneration decisions were made and could be more easily justified. Overall, the schedule would provide greater context to the debate, improving understanding of the importance of rewarding the providers of capital and labour and how choices between the two were reached, while at the same time reinforcing the importance of the business reinvesting in its future.



**George Henderson,**  
*Global Index  
Linked Fund  
Manager*

Oil prices have risen following violence in the Middle East, while energy policies are under review globally as the Japanese nuclear disaster unfolds. Oil (and energy) is a significant component of economic expenditure; transportation accounts for approximately 15% of developed world inflation indices, with gas and electricity adding further direct energy price exposure for consumers and businesses alike.

Energy price shocks have repercussions for all markets, but the effect on bonds - and index-linked bonds in particular - is most interesting. On the one hand there is a negative impact from the effects of short term inflation, while on the other, lower longer term economic growth is a positive.

Index-linked bonds perform particularly well in this type of environment (i.e. stagnant growth combined with higher inflation - referred to in stressed cases as 'stagflation'). As all cashflows are linked to inflation, index-linked bonds benefit from any price increases, while their bond characteristics make them an attractive investment in a low growth environment. In one of the more volatile cases recently, the price of 2040 US TIPs rallied 11% from its lows.

Energy price increases don't affect inflation markets equally, as different governments have different tax policies. Specifically, the higher the tax, the more muted energy price moves become. The US taxes energy the least, so energy price changes feed most directly into inflation. Not surprisingly, the US TIPS market has benefitted the most of late. US inflation expectations for the next five years are now 0.4% higher than mid February, compared with 0.2% in Europe; UK expectations are unchanged.

Our view is that inflation will abate over the medium term to levels broadly in line with official Central Bank targets. However, the risk to this view is to the upside and recent events illustrate the rapidity of price moves and hence the importance of inflation protection.

Source: rlam as at 21 March 2011 unless otherwise stated.

rlam is a marketing brand including the following companies: Royal London Asset Management Limited registered in England & Wales number 2244297; Financial Services Authority (FSA) register number 141665. Royal London Pooled Pensions Company Limited registered in Scotland number SC048729; FSA register number 110456. Royal London Unit Trust Managers Limited registered in England & Wales number 2372439; FSA register number 144037. Royal London Cash Management Limited registered in England & Wales number 19632; FSA register number 121844. All of the above are authorised and regulated by the Financial Services Authority. It also includes Royal London Asset Management Bond Funds Plc registered in Ireland number 364259 and regulated by the Central Bank of Ireland.

All these companies are subsidiaries of The Royal London Mutual Insurance Society Limited registered in England and Wales number 0099064 (FSA registration number 117672). Head office: 55 Gracechurch Street, London EC3V 0RL.

Our reference: 140-PRESS-03/2011-SS