

IAPF Seminar – 8th January 2008

Pension Fund Weightings in Irish Equities

Rory Gillen, Director, Merrion Landsbanki

January 2008



Irish Equity Weighting in Domestic Pension Funds

- **ISEQ Represents**
 - Circa 1% of the European Equity Markets
 - Circa 0.3% of the FTSE World Equity Index
- **Average ISEQ Weightings in Irish Pension Funds – 16% !!!**
- **That's Overweight !!!**

Issue Can Be Argued Looking Back & Looking Forward

- **Have High Weightings Been Justified in the Past ?**
- **Can High Irish Equity Weightings Continue to Be Justified ?**
 - In Terms of the Outlook
 - In Terms of Added Risk

Irish Equity Weighting in Domestic Pension Funds

- **Have High Weightings Been Justified in the Past**
- **Can High Irish Equity Weightings Continue to Be Justified**
 - In Terms of the Outlook
 - In Terms of Added Risk

Historical Equity Returns (1970 – 2007)

| Year | Compound p.a. Returns (%) | | | | |
|-----------|---------------------------|-------------------|---------------|-----------------------------|---------------------|
| | Ireland ISEQ | UK FT AllShare | US S&P 500 | Europe MSCI Europe-ex UK | Equities Average |
| 2000-07 | 6.3 | 3.4 | 1.5 | 3.3 | 3.6 |
| 1990s | 16.6 | 14.0 | 18.0 | 16.4 | 16.3 |
| 1980s | 24.8 | 22.2 | 17.6 | 19.7 | 21.1 |
| 1970s | 13.4 | 10.3 | 5.9 | 3.2 | 8.2 |
| 1970-2007 | 15.6 | 12.8 | 11.0 | 10.8 | 12.5 |

Real Equity Returns (After Inflation)

| Year | Compound p.a. Returns (%) | | | | |
|-----------|---------------------------|-------------------|---------------|------------------------|---------------------|
| | Ireland ISEQ | UK FT AllShare | US S&P 500 | Europe MSCI Eur-xUK | Equities Average |
| 2000-07 | 7.8 | 0.1 | -1.7 | 0.4 | 1.7 |
| 1990s | 13.9 | 10.0 | 15.0 | 13.7 | 13.2 |
| 1980s | 16.1 | 14.4 | 12.5 | 16.8 | 14.9 |
| 1970s | -3.9 | -2.5 | -2.2 | -1.8 | -2.6 |
| 1970-2007 | 7.0 | 5.7 | 6.1 | 7.6 | 6.6 |

Above Average Inflation-adjusted Returns, but Lower Than the European Markets Over the Period in Question

Risk-adjusted Returns (Sharp Ratio)

| Sharp Ratio (covering 1970 – 2007) | | | | |
|------------------------------------|-----------------|-------------------|---------------|------------------------|
| | Ireland ISEQ | UK FT AllShare | US S&P 500 | Europe MSCI Eur-xUK |
| 1970-2007 | 33.17 | 23.9 | 31.73 | 33.02 |

The Higher the Ratio the Better.....Hence, on a Risk-adjusted Basis, the Irish Market Produced the Best Returns over the Period in Question

Superior Returns – Why ?

- **Disproportionate Benefits From Joining the EU in 1972**
 - Structural & Cohesion Funds
 - Educated Workforce, Plentiful Supply of Labour & English language – Ideal Platform to Europe for US Multi-nationals
 - Eventually Resulting in the Celtic Tiger
- **Small-cap Effect – ‘Elephants Don’t Gallop’**
- **Reduction in the Corporate Tax Rate on Irish Profits (1998 – 2003)**
- **Better Businesses ?**
 - Superior Business Attributes
 - Superior Management

The Drivers Behind Those Returns

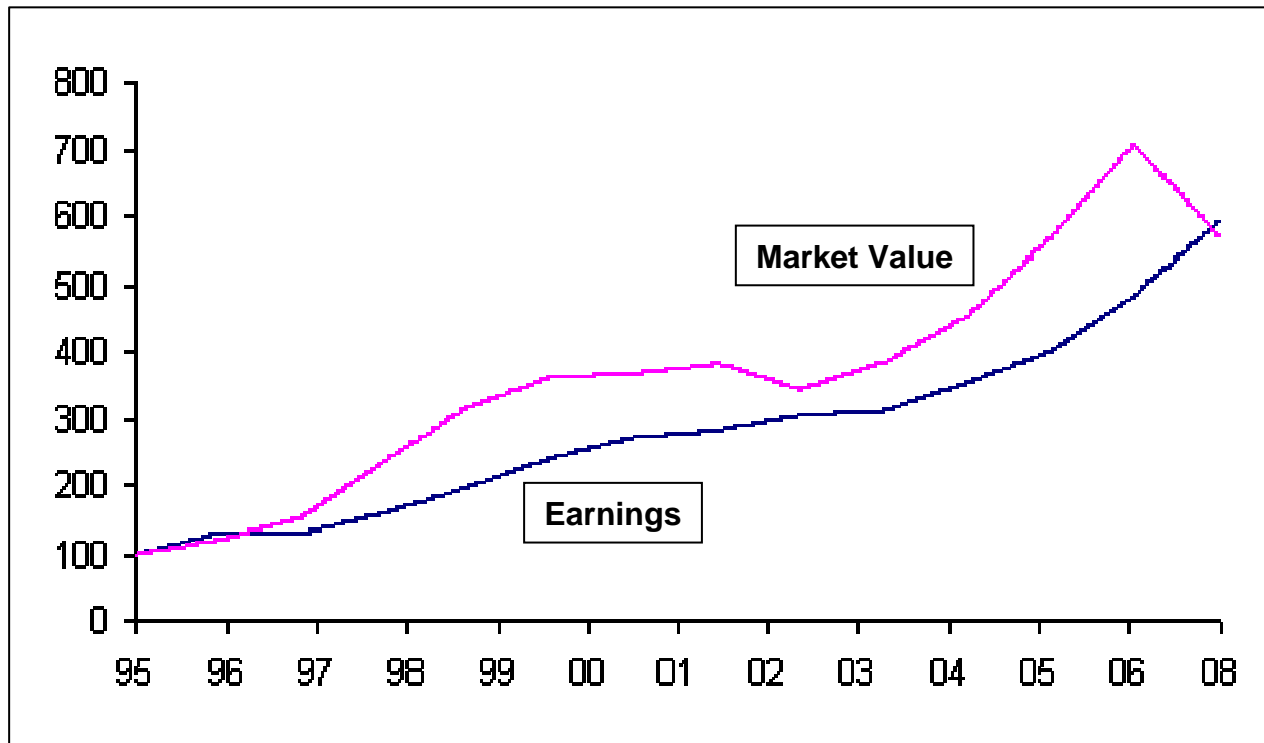
- **In Short, Earnings Growth**

The Drivers Behind Those Returns

- ISEQ Earnings Growth (1995 – 2007) —————→ 14% c.p.a.
- US S&P 500 Earnings Growth (1995 – 2007) —————→ 8% c.p.a.

Note: Normalised Earnings (i.e. pre-exceptionals)

ISEQ Growth Profile (1995 - 2007)



14% c.p.a Growth in ISEQ Earnings From 1995 - 2007 inclusive.

13.5% c.pa. Returns From ISEQ Over That Same Period.

Note: Market Value & Earnings Statistics Rebased to 100 in 1995 - all stats exclude Elan Corp

The Drivers Behind Those Returns

- **i.e. No Benefit From any Re-rating of the Irish Market**
 - i.e. No P/E Ratio Expansion on the Back of Superior Growth Characteristics
 - Well Not After Decline in 2007 Anyhow

Have High Irish Equity Weighting in the Past Been Justified ?

- **An Unqualified YES**
- **But Looking in the Rear-view Mirror Scores No Points**

Irish Equity Weighting in Domestic Pension Funds

- **Have High Weightings Been Justified in the Past**
- **Can High Irish Equity Weightings Continue to Be Justified**
 - In Terms of the Outlook
 - In Terms of Added Risk

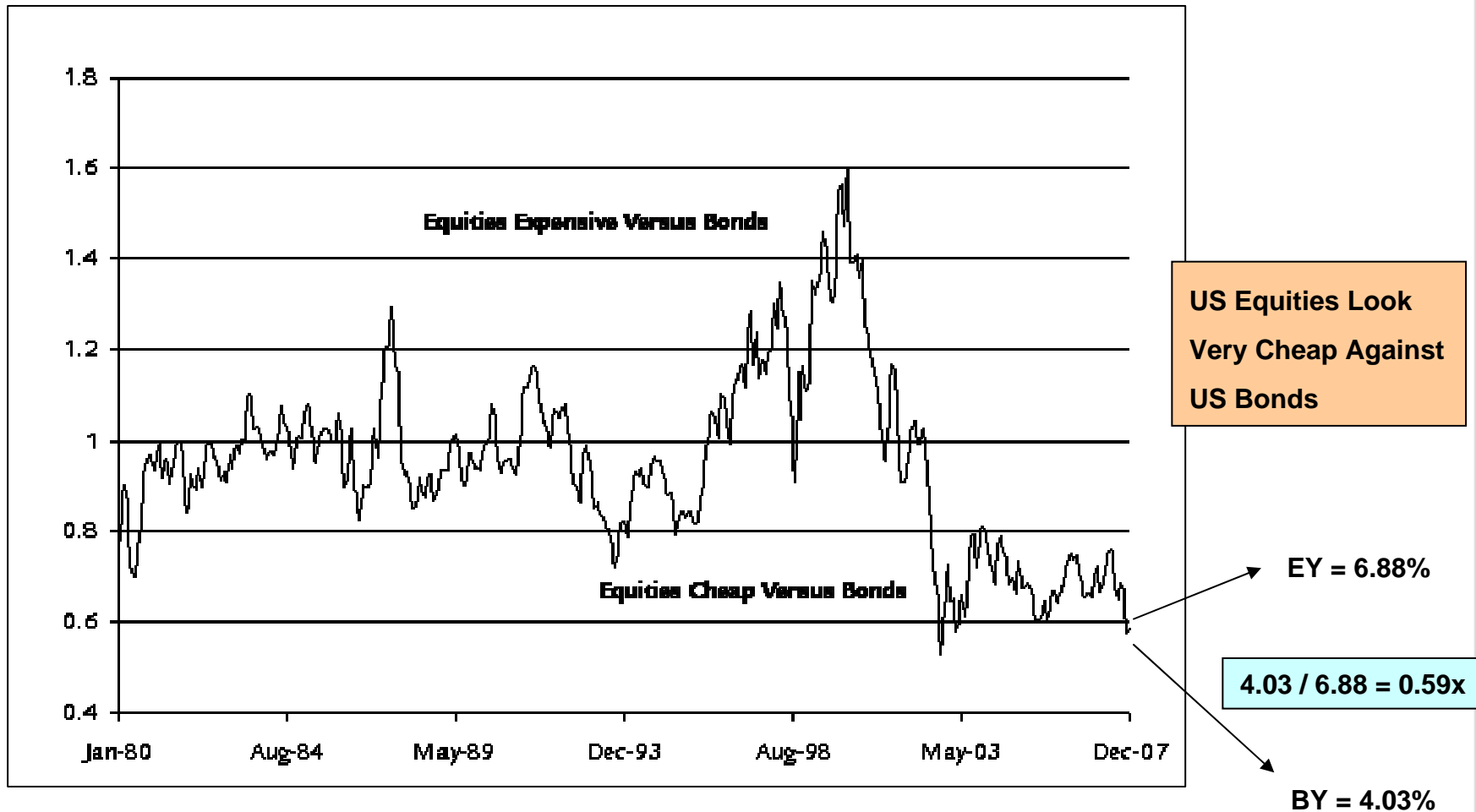
The Outlook For Equities in General

Three Drivers of Stock Market Returns

- (i) Earnings Yield v Bond Yield
- (ii) Earnings Growth Prospects
- (iii) Sentiment

Taking Our Lead From US Equities

US Bond / Earnings Yield Ratio



But US Profits At a Cyclical Peak !!



US Corporate Earnings as a % of US Economic Output Are at a Peak....At Best, Earnings Growth Prospects Are Sub-par Looking Forward

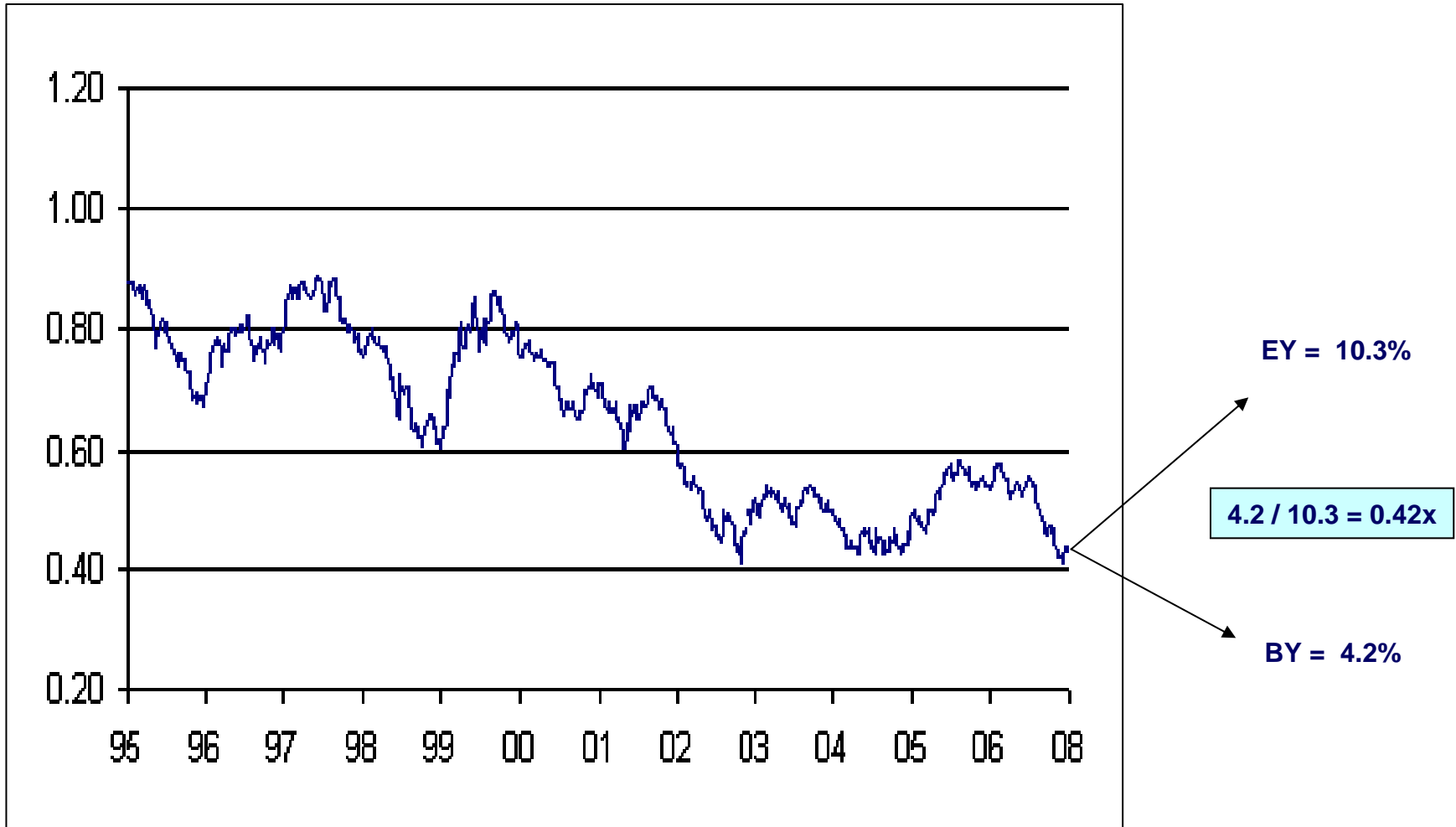
Summarising The Outlook For US Equities

Three Drivers of Stock Market Returns

| | | |
|-------|-----------------------------|----------|
| (i) | Earnings Yield v Bond Yield | Positive |
| (ii) | Earnings Prospects | Negative |
| (iii) | Sentiment | Neutral |

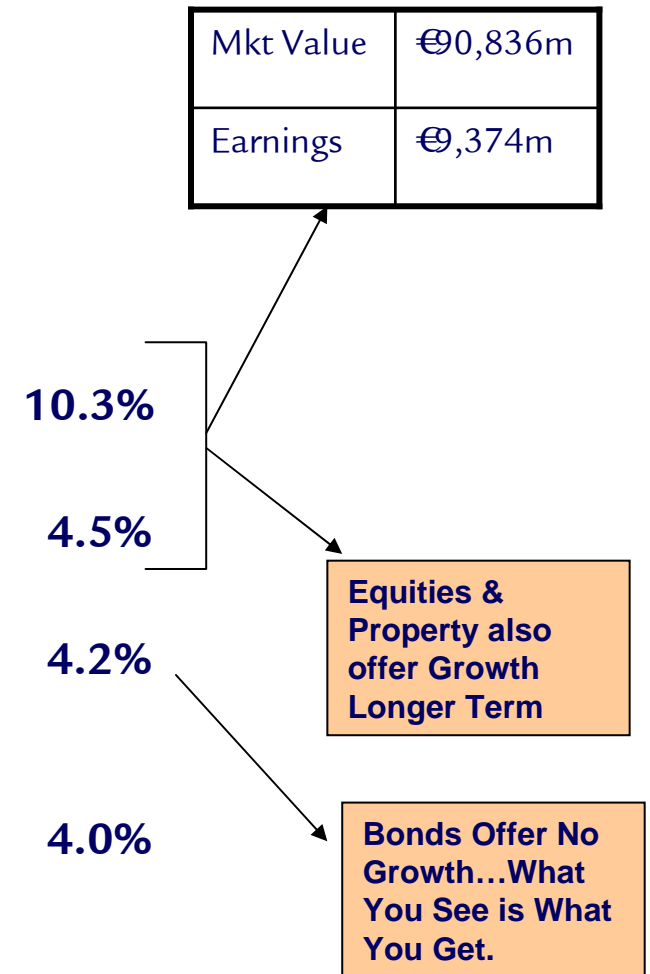
1 1/2 out of 3 Ain't Bad.....It Was 0 out of 3 in Early 2000

Irish Bond v Earnings Yield Ratio



ISEQ: Value For Money ?

- Irish Equities (Earnings Yield)
- Irish Commercial Property (Rental Yield)
- European 10-year Bond Yield
- European Overnight Interest Rates



Note: Market Value & Earnings Statistics exclude Elan Corp. All Stats at 31st Dec 2007

Summarising Prospects For ISEQ

- **In terms of the Outlook....Excellent Value in Irish Equities**
 - Huge Margin of Safety in ISEQ Earnings Yield (Already Priced For a Significant Earnings Decline...Which May or May Not Occur)
 - Better Earnings Yield on Offer in ISEQ compared to Most International Equity Markets – (10.3% on ISEQ compares to 6.9% on the S&P 500)
 - Irish Equities Offer Compelling Value versus Irish Commercial property

Outlook – Scenario 1

- **Assume Earnings Decline By 20%**
- **Earnings Yield Drops to 8% - Still Strong Cover For Dividends**
- **Dividend Yield on ISEQ Currently 3.1%**

- **Return over the Medium Term ?**
 - Dividend Yield of 3.1% plus Growth in the Dividend Yield (say 6-7% per annum)...Underpinned By Growth in Earnings
 - Sustainable Returns From ISEQ of 9-10% per annum Going Forward

- **Much Better Than Bonds**

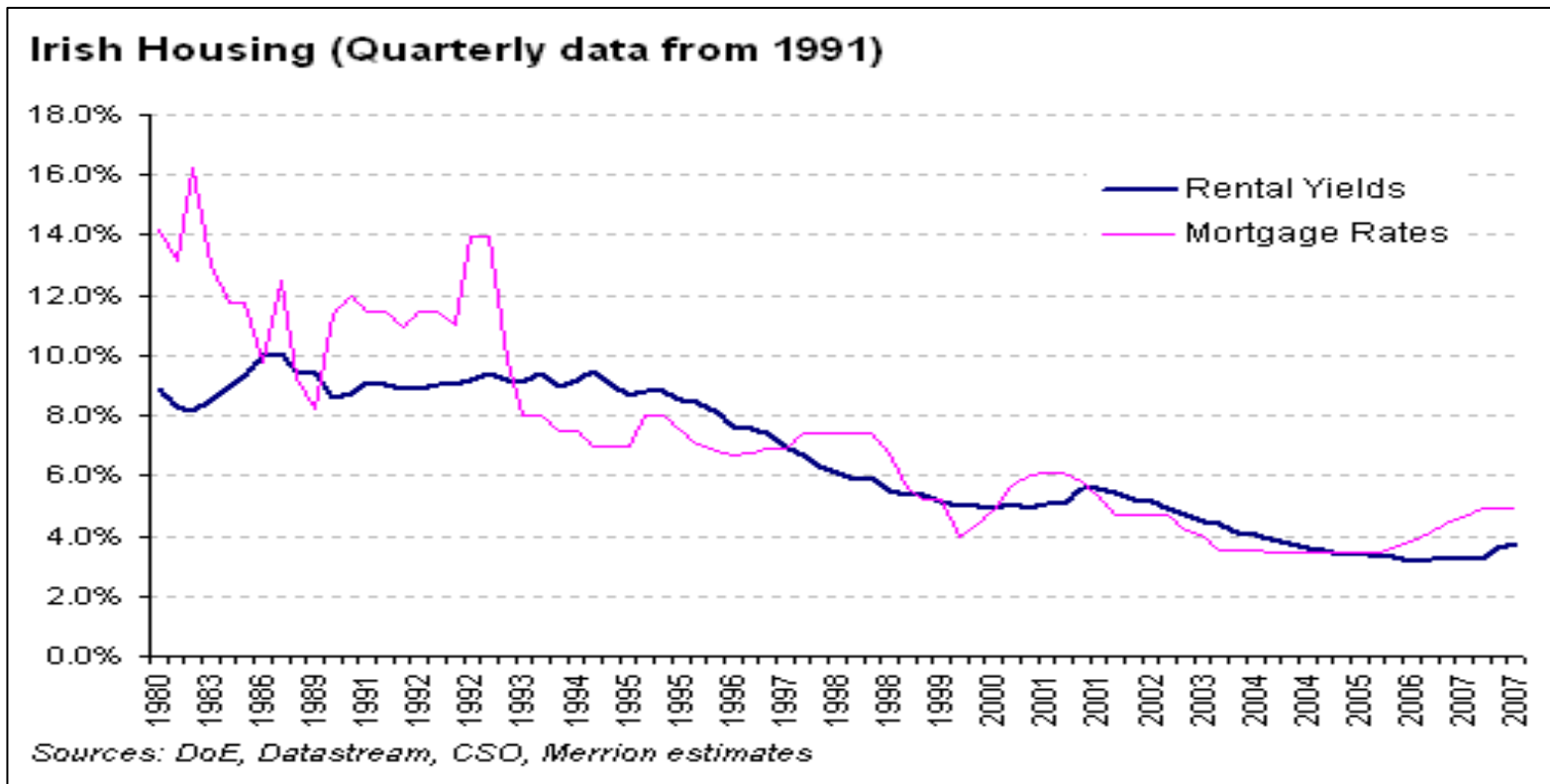
Outlook – Scenario 2

- **Scenario 1 plus Earnings Yield Contraction (or P/E Expansion)**
 - To reflect Lower Bond Yields (Lower Interest Rates)
- **Earnings Yield Contracts From 8% to 6%**
- **Further 25% (once-off) Boost to Returns**

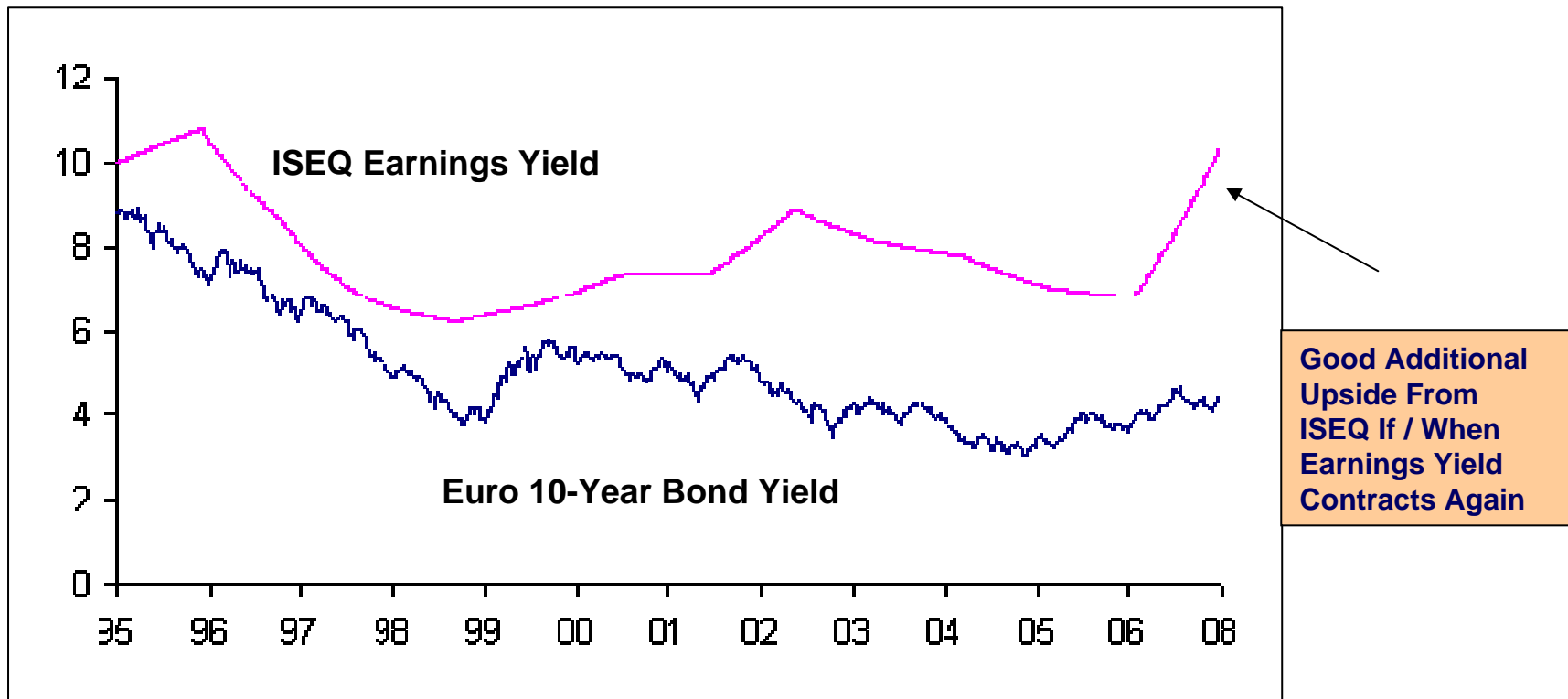


Rental Yield Contraction in Irish Property

- **Lower Rental Yield on the Back of Lower Interest Rates (Bond Yields)**



Why No Earnings Yield Contraction in Irish Equities ?



Irish Equity Weighting in Domestic Pension Funds

- **Have High Weightings Been Justified in the Past**
- **Can High Irish Equity Weightings Continue to Be Justified**
 - In Terms of the Outlook
 - In Terms of Added Risk

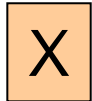
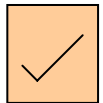
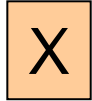
Key Question is – Are the Risks Higher Today Than in the Past ?

Are the Risks Higher Today Than in the Past ?

- **Certainly, the Risks Attached to Growth Are Higher**
- **Economy Now More Mature..... Favourable Tailwinds Unlikely to be as Helpful**
 - That Said, Only Circa 35-37% of ISEQ Profits Are Generated From Irish Economy
- **The Usual Over-reliance on (Cyclical) Financial & Building Materials Sectors Still There...and is a Negative**
- **ISEQ Offers Practically No Exposure to the Energy & Commodity Cycles - the Alternative Uncorrelated Asset Classes Which Are Currently in Bull Markets**

Key Question – Can ISEQ Deliver Better Returns From Here ?

- **Disproportionate Benefits From Joining the EU in 1972**
- **Small-cap Effect – ‘Elephants Don’t Gallop’**
- **Reduction in the Corporate Tax Rate on Irish Profits (1998 – 2003)**
- **Better Value on Offer ?**
- **Better Businesses – Better Management ?**



ISEQ - Better Businesses ?

- **CRHUnrivalled Track Record & Business Model Intact**
- **AIBDominates the Irish Market...Sensible Overseas Expansion**
- **BOI.....Also Dominates the Irish Banking Market**
- **Anglo.....Unsure**
- **Elan..... No Reason to Invest**
- **Ryanair.....Unassailable Competitive Advantage in a Growth Market**
- **IL&P.....Dominates Irish Life & Savings Markets ...Growth Markets**
- **Kerry.....Key Player in Global Defensive Food Ingredients Markets**
- **IAWS..... Management-led Growth Story in Defensive Sectors**
- **Kingspan....Dominant Player in Structural Growth Markets**
- **DCC.....Ireland's Answer to GE....They Simply Know How to Grow**
- **Grafton.....Management-led Growth Story...in the UK to Date**

Superior Management Stories ?

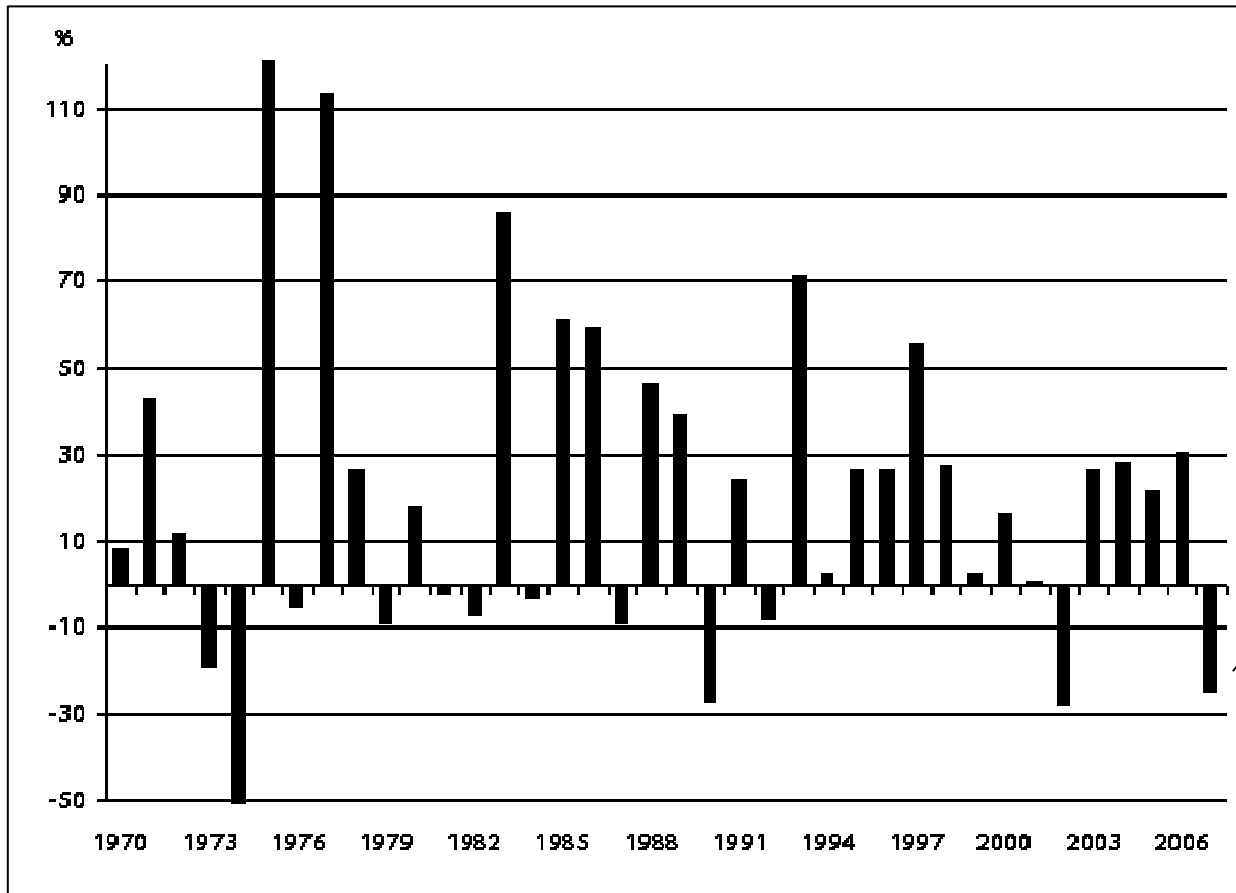
- **Most Likely**
- **To Dominate Your Home Market and to Have Used That as a Platform From Which to Expand Abroad is the Test**
 - Many Irish plc Have Passed That Test

Conclusion

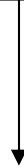
- **There is No Black & White Answer**
- **My Personal View is that the Better Value Currently on Offer in ISEQ Together With the Strong Business Models & Superior Management Stories Justify High Irish Equity Weighting**
 - Diversification For the Sake of it Does Not Increase Returns and Does Not Lower Risk
- **But if You Disagree....There Will Surely Be a Better Time to Recommend Adjusting Weightings**

Why Now ?

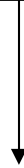
ISEQ – Annual Returns (1970 – 2007)



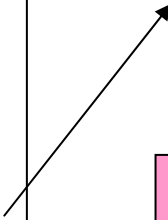
Why Are We Discussing the Issue Now ?



Probably Because the ISEQ has Had a Poor Year – Only Four Similar Years Since 1970



Pension Fund Advisors & Fund Managers Need to Take Care Not to Repeat the Errors of 1999!!



Thank You