Quarterly Report 30 June 2013

Dorset County Pension Fund

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YOUR PORTFOLIO

Our philosophy

We aim to achieve long-term outperformance by active management and taking advantage of marketing inefficiencies. We believe in value investing and generally take investment positions for their medium term. This particularly applies to credit bonds where we are prepared to take positions away from the benchmark. We strive to ensure that risk is taken appropriately and that significant issuer diversification is present within the portfolios we manage.

Investment process

Macroeconomic outlook drives duration and yield curve positions. Government stock selection is influenced by our proprietary bond model, which highlights price anomalies. For non-government bonds, macroeconomic views complement stock specific analysis. We place particular emphasis on covenant protection, structure and security in the analysis of corporate debt. Stock diversification is a fundamental aspect within credit portfolios.

Fund performance objectives

Subject to the constraints set out in these Investment Guidelines the objective of the Fund is to outperform the benchmark by 0.80% per annum (gross of fees) on a rolling three year basis. Performance will be measured, gross of fees, against the Benchmark return. The performance of the Benchmark will be calculated by such benchmark constructor as the Customer from time to time nominates. The Benchmark's performance history will be retained once updated with the revised Benchmark's return being geometrically linked to that calculated prior to the revision.

Fund asset allocation and benchmark ranges

Benchmark index*	Benchmark allocation (%)	Actual allocation (%)**
Conventional credit bonds iBoxx Sterling Non-Gilt Over 5 Year Index	100.0	100.0

* New benchmark commenced 2 July 2012: iBoxx Sterling Non-Gilt Over 5 Year Index.

** Includes overseas bonds, derivatives and CDs where held within the portfolio or benchmark.

Fund restrictions

Please refer to your IMA for any investment constraints.

Portfolio value

	Total (£m)
30 June 2013	**183.30**
31 March 2013	189.45
Change over quarter	(6.15)
Net cash inflow (outflow)	-

EXECUTIVE SUMMARY

Performance

- The fund gave a gross return of -3.23% during the quarter, compared with a benchmark return of -3.80%.
- Credit sector and stock selection were the main drivers of performance.

The economy and bond markets

- Recent data suggesting global economic stabilisation has been offset by weakness in Emerging Markets. UK gross domestic product (GDP) grew by 0.3% in the first quarter, and Consumer Price Index (CPI) inflation rose to 2.7% in May. The US Federal Reserve (Fed) signalled early 'tapering' of quantitative easing purchases. The Bank of England made no significant policy change, leaving policy and quantitative easing unchanged at 0.5% and £375bn respectively, although forward rate guidance is expected in future.
- Conventional gilts returned -3.8% over the second quarter, the ten year yield rising to 2.4%. Medium dated gilts underperformed long and short dated gilts. A new ultra long 2068 maturity gilt was issued via syndication. Index linked gilts returned -6.5%, the ten year real yield rising to -0.4%. Short dated index linked bonds underperformed as global commodity prices and inflation expectations fell, and supply was concentrated at shorter maturities. Combined with overseas selling of shorter dated bonds and pension fund buying of longer dated bonds, the real yield curve flattened. Longer dated implied inflation (breakeven) rates rose to their highest levels since mid 2011. Investment grade sterling credit returned -2.9%, outperforming gilts. Sector returns were all negative, and tier 1 bank debt outperformed the overall credit market, as did lower rated and shorter dated bonds.

Investment outlook

- We expect gilt yields to rise over the year but remain volatile. Given low rate rise expectations, we expect the yield curve to remain relatively flat. However, we expect the real yield curve to steepen and shorter dated bonds to outperform under the weight of longer dated supply. We believe that the pricing of credit bonds undervalues the asset class, relative to government bonds, and that recent rises in gilt yields will underpin positive returns from sterling credit markets.

The key views within your portfolio

- A significant underweight in supranational bonds as we expect credit bonds to outperform.
- Duration is similar to benchmark; we expect higher UK government bond yields in the second half of 2013 offset by lower credit spreads.
- A bias towards asset backed securities, an area that we believe still offers the best risk/return characteristics.
- An overweight position in financial debt where we believe yields are attractive.

FUND PERFORMANCE

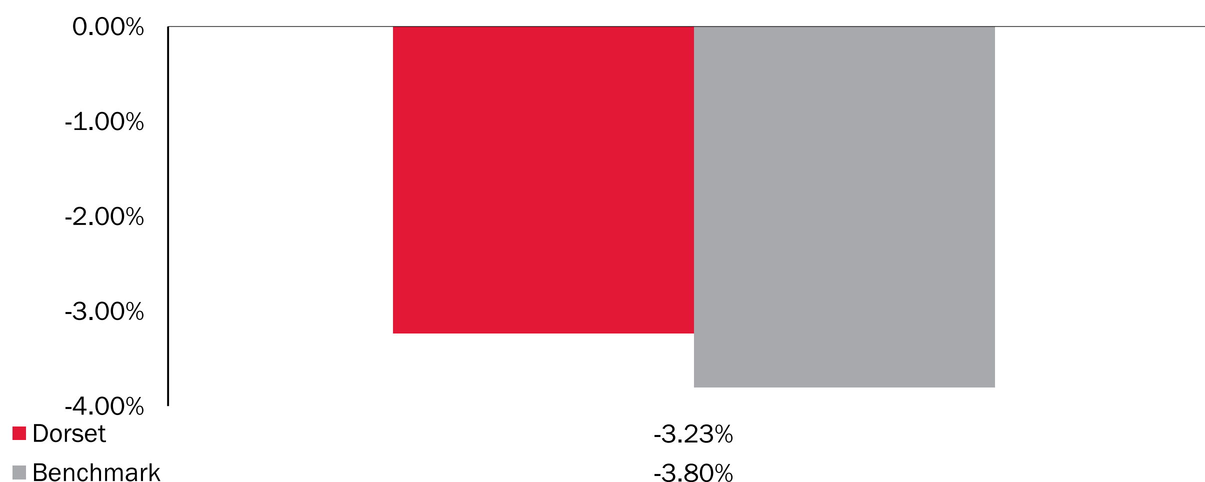
The table below shows the gross performance of the bond fund and the benchmark index for the previous quarter, year to date, rolling 12 months, 3 years, 5 years and since inception:

Performance (%)

	Dorset	Benchmark	Relative
Q2 2013	-3.23	-3.80	0.57
Year to date	-0.77	-2.11	1.34
Rolling 12 months	10.12	6.77	3.35
3 years p.a.	12.71	11.97	0.74
5 years p.a.	11.69	11.02	0.67
Since inception 02.07.07p.a.	9.25	10.06	-0.81

- The fund gave a gross return of -3.23% over the quarter, compared with a benchmark return of -3.80%.
- Credit sector and stock selection were the main drivers of performance, especially the underweight exposure to supranationals and consumer orientated debt; duration and yield curve positioning were broadly neutral for overall fund returns.

Quarterly performance

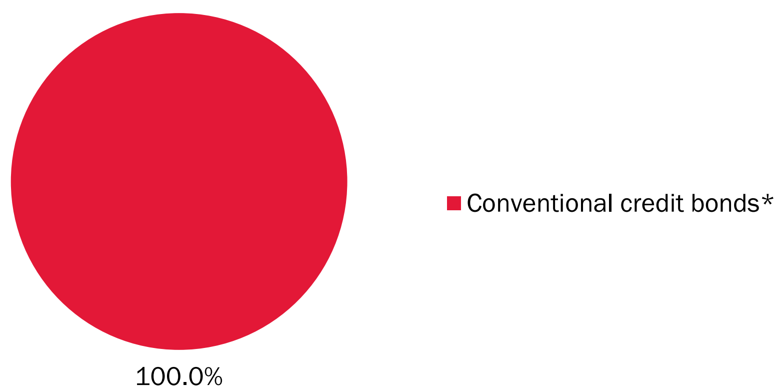


The total fund returns in the above table include the impact of the cash holding during the quarter.

DRIVERS OF PERFORMANCE

Asset allocation positioning

Asset allocation



* Includes overseas bonds, the Royal London Sterling Extra Yield Bond Fund and CDs where held within the portfolio or benchmark.

What we thought	What we did	What happened	Effect on portfolio
We expected that corporate bonds would outperform UK government bonds over the quarter.	We sold out of a small gilt position during the quarter.	Corporate debt marginally outperformed sovereign bonds.	Asset allocation was not a factor in relative performance.

DRIVERS OF PERFORMANCE

Duration positioning

	Total fund
Dorset	9.9
Benchmark	9.7

Source: rlam. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio. Includes overseas bonds, derivatives and CDs where held within the portfolio or benchmark.

- A broadly neutral duration position was maintained throughout the period, reflecting our view that, while we remain positive on the outlook for further credit spread compression in 2013, we are cautious on potential volatility of government yields despite their sharp rise over the quarter.

Duration positioning

What we thought	What we did	What happened	Effect on portfolio
We expected gilt yields to rise.	We maintained close to benchmark duration; we expected spread tightening to offset higher gilt yields.	While credit spreads narrowed marginally, this was not enough to offset the significant rise in gilt yields in the quarter.	Duration was not a material factor in performance.

DRIVERS OF PERFORMANCE

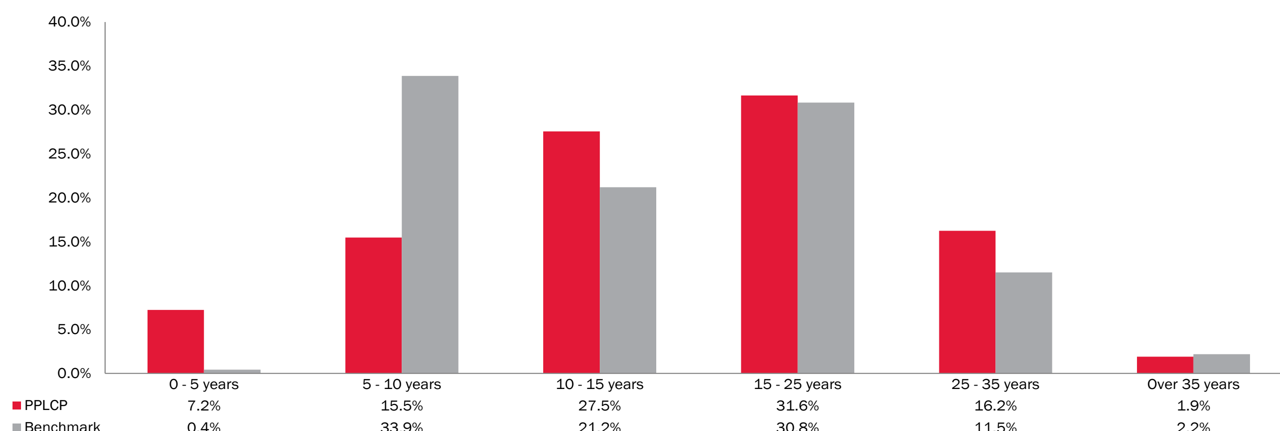
Portfolio yield & yield curve positioning

	Total fund (%)
Dorset	4.9
Benchmark	4.3

Source: rlam. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio. Includes overseas bonds, derivatives and CDs where held within the portfolio or benchmark.

- The yield on the portfolio increased during the quarter by 0.3%, reflecting the increase of both government bond and credit yields during the period.
- The high yield of the portfolio relative to the benchmark primarily reflects the low exposure to supranationals as well as the exposure to subordinated financial debt (bank and insurance) and the Royal London Sterling Extra Yield Bond Fund.

Yield curve positioning



Source: rlam. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio.

Yield curve positioning

What we thought	What we did	What happened	Effect on portfolio
We thought that credit spreads were most attractive in the 15 to 30 year range.	The fund remained biased towards longer dated bonds.	On a duration adjusted basis, credit bonds at longer maturities outperformed.	Yield curve positioning was not a material factor in performance.

DRIVERS OF PERFORMANCE

Portfolio stock selection

Portfolio review

What we thought	What we did	What happened	Effect on portfolio
We expected that corporate bonds would outperform supranational debt.	A minimal exposure to supranational bonds was held in the quarter.	Corporate debt marginally outperformed supranational bonds.	The underweight position in supranational debt was a small positive contributor to performance.
We preferred a combination of covered bank bonds and subordinated bank debt to senior bonds.	We maintained overweight exposures to covered and subordinated bank debt.	Covered bonds performed poorly whilst tier 1 bank debt, while volatile, outperformed the overall credit market.	Overweight exposure to covered bonds detracted as senior bonds performed better. This strategy was offset by the performance of tier 1 debt.
We thought that high profile consumer orientated bonds were unattractively priced.	We maintained underweight exposure to consumer bonds, such as Wal-Mart, Procter & Gamble and Glaxo.	Consumer orientated debt continued to underperform.	Underweight exposure to high profile consumer debt supported fund returns.
We believed that secured bonds were undervalued relative to unsecured debt.	We maintained significant overweight exposures to sectors offering enhanced security e.g. asset backed securities (ABS), social housing and investment trusts.	Asset backed bonds generally mirrored movements in the wider credit market.	The exposure to secured and ABS bonds was not a material factor in relative performance.

DRIVERS OF PERFORMANCE

Portfolio stock selection

Portfolio activity

- Despite the subdued nature of credit markets during the second quarter, the fund participated in several attractively priced new deals. We added to the fund's insurance exposure through a debut issue from the UK insurance company **Liverpool Victoria**, rated BBB and offering a yield of 6.5% for ten years, with a penal rate payable should the company exercise its option to defer repayment, together with a new dual tranche subordinated issue from **Scottish Widows** (insurance arm of Lloyds banking Group). The fund participated in the 30 year tranche that was priced at 400 basis points over the 30 year benchmark gilt. This was the first long dated subordinated deal since the financial crisis and was met with strong demand, reflected in the bond's performance following the launch.
- **The AA**, the UK's largest roadside assistance company, issued two senior bonds rated at BBB- and a junior sub investment grade bond rated BB through a Whole Business Securitisation structure. Proceeds were used to refinance debt put in place in 2007, when the business was purchased by its current private equity owners. As the senior bonds benefit from security over the assets and cash flows of The AA, we believed they were attractively priced at between 3.3% to 3.5% over underlying gilts.
- In addition, US telecom exposure was increased by participating in a £1bn long dated placing by **A&T**. The fund also purchased 10 year bonds from **BUPA**, the health insurance business, offering a 5% yield, as well as participating in a new issue of secured bonds from **Unite**, the university student accommodation business.
- Secondary market opportunities during the quarter involved adding to existing asset backed and secured positions in **Yorkshire Water** and **THFC** and **EDF** in the utility sector.
- Key sales during the quarter included exiting **Co-Op Bank** through sales of senior and subordinated bonds. This reflected the deterioration in financial performance and the multiple notch downgrade of the bank by Moody's in May. We have retained a position in the **Co-Op Group**.
- During the quarter we took off a derivative position; at the end of the quarter the fund had no outstanding derivative positions.

PORTFOLIO RISK MANAGEMENT

Our risk management process

Risk is managed by your fund manager. To aid risk management RLAM employs the thinkFolio portfolio management system which allows the manager to monitor in real time the drivers of performance: asset allocation, interest rate positions, sector allocation and stock selection.

Risk within your portfolio is measured by RLAM's Portfolio Risk team, using the UBS Delta system; the team has responsibility for undertaking an independent review of risk positions in your fund. The Portfolio Risk team is independent of the fund management function and reports to RLAM's Chief Investment Officer; a monthly assessment of portfolio risk is sent to the RLAM Board. The Portfolio Risk team undertakes weekly meetings with fund managers and the Head of Fixed Interest. Risk positions are reviewed and relevant actions recorded.

Risk measures

	Tracking Error (bps p.a.)				Spread
Sector	Spread	Rates	Inflation	Total	DTS
Banks & Financial Services	28.51	-0.57	0.00	27.93	1.59
Cash	0.00	0.00	0.00	0.00	0.00
Consumer Goods	-1.58	8.70	0.00	7.13	-0.38
Consumer Services	3.78	5.87	0.00	9.65	0.02
Covered	1.47	-7.41	0.00	-5.94	0.22
Foreign Sovereigns	-1.15	2.25	0.00	1.11	-0.20
General Industrials	-1.04	5.69	0.00	4.65	-0.21
Insurance	7.41	0.37	0.00	7.79	0.52
Investment Trusts	9.32	-6.83	0.00	2.49	0.60
Real Estate	13.19	-8.92	0.00	4.27	0.92
Social Housing	11.61	-10.43	0.00	1.18	0.82
Structured	48.44	-32.15	0.00	16.29	2.82
Supranationals & Agencies	-3.95	40.09	0.00	36.14	-0.80
Telecommunications	0.02	3.45	0.00	3.47	-0.15
Utility	3.26	2.84	0.00	6.10	0.25
Total	**119.28**	**2.96**	**0.00**	**122.24**	**6.01**

Smaller contribution Larger contribution

- The above table provides a breakdown of the total forecast tracking error of your portfolio by RLAM sector. Tracking error arises from differences in portfolio holdings to that of the benchmark, and is attributed, via the risk model, to Credit Spread risk, Interest Rate risk (both in overall duration and curve positioning terms) and, where applicable, Inflation Risk. Total tracking error takes into account the portfolio exposures, versus benchmark, to these risks, as well as the interaction between them. A negative contribution to the total tracking error indicates that the positions held within that sector serve to make the tracking error lower than it would otherwise be were those positions not held.

- The overall tracking error decreased over the quarter, reflecting the decline in credit yield spreads; tracking error risk is concentrated in the 'spread' risk associated with exposures to credit bonds. The largest overall source of total tracking error is in relation to the portfolio's significant underweight exposure to Supranationals and Agencies. There is no inflation related risk in the portfolio.

- Overall "Duration times Spread" fell marginally over the quarter, reflecting the decline in credit yield spreads. The largest source of DTS risk is in relation to the portfolio's overweight exposure to the Structured bond sector.

ECONOMIC REVIEW

Key points

- Recent data on the global economy has been consistent with some stabilisation in growth prospects in Advanced Economies, though this has been offset by weakness in Emerging Markets.
- The US Federal Reserve has signalled an earlier than expected "tapering" of their quantitative easing purchases.
- The Bank of England made no significant policy change during the quarter, though some form of forward rate guidance is anticipated in the third quarter.

Growth

- Global growth prospects remained subdued during the quarter, particularly in the Euro area; in April, the International Monetary Fund (IMF) revised down its forecast for 2013 global gross domestic product (GDP) growth to 3.3%. The US economy continued to grow at a moderate pace, with the level of GDP now above its pre-crisis peak. The Euro area remained in recession, as balance sheet repair and tight credit conditions continued to act as a constraint on economic activity.
- US GDP growth was estimated to be 1.8% (annualised) in the first three months of 2013, boosted by an unwinding of the temporary impact of bad weather, although payroll tax rises did have some impact on consumption. Higher consumer confidence since then is likely to have strengthened second quarter growth. The unemployment rate fell to 7.6% in May 2013, from its peak of 10% in October 2009. This improvement has been supportive of household spending. However, the fall in the unemployment rate largely reflects a decline in the proportion of people who are actively seeking work, rather than a rise in the proportion who are employed.
- In the Euro area, GDP fell by 0.2% in quarter one 2013, a slower rate of decline than in the final quarter of 2012. Output in Germany was slightly weaker than expected, possibly reflecting a cold weather effect which should unwind in quarter two. Indicators of Euro area activity have pointed to a stabilisation in output in the second quarter, including rises in the Purchasing Managers' Indices (PMIs).
- Japanese output grew by 0.9% in the first quarter, although it was too soon to have seen the impact of recent announcements on fiscal and monetary policy. A more long lasting improvement in economic growth will depend on structural reforms within the new policy package. However, there is as yet little detail on the form that these will take. In China, following the easing in Chinese GDP growth in the first quarter, activity indicators in the second quarter did not suggest any firming in activity. More generally, as China rebalances demand away from investment and exports towards consumption, growth is likely to be somewhat lower than in recent years.
- In the UK, data tended to surprise on the upside during the quarter. GDP grew by 0.3% in the first quarter, and official monthly data and business surveys suggest that growth will be stronger in the second quarter. The latest GDP revisions now suggest that the recession of 2008/09 was even deeper than previously thought, while the subsequent weak recovery means that output remains 3.6% below its previous peak, compared with an earlier estimate of 2.9%. The labour market continues to recover much more quickly than expected, with a significant increase in full time employment over the past year. However, wage pressures remain low.

Inflation

- UK Consumer Price Index (CPI) inflation rose to 2.7% in May, from 2.4% in April, largely reflecting the early Easter effect on air fares. The continuing impact of higher university tuition fees and rises in domestic utility prices should keep CPI closer to 3.0% than 2.0% for much of 2013.

Interest rates

- With the macroeconomic backdrop remaining weak, monetary policy remained supportive during the quarter, with some central banks loosening policy further.
- The European Central Bank cut the interest rate on its main refinancing operations by 25 basis points in May, while the Bank of Japan launched a major new monetary stimulus package as part of a wider set of policy measures involving both fiscal stimulus and structural reform.
- In December 2012, the Federal Reserve had committed to continue its open-ended purchases of assets until it observed a substantial improvement in the outlook for the US labour market, and provided inflation expectations remained anchored. Towards the end of the quarter, however, the focus turned to the possible timing of a slowing in the pace of monetary expansion through "tapering" of quantitative easing purchases.
- In the United Kingdom, the Monetary Policy Committee kept its policy rate and the stock of purchased assets unchanged. In April, an extension to the Funding for Lending Scheme was announced by the Bank of England and HM Treasury.

Currencies

- Trade weighted sterling was flat during the quarter, following a sharp fall in the early part of the year, as the improvement in economic data boosted sentiment.

BOND MARKET REVIEW

Financial & corporate bonds

Key points

- Investment grade sterling credit bonds returned -2.9% in the quarter; returns in all sectors were negative.
- Credit spreads narrowed over the quarter, moving from 1.7% to 1.6%.
- On a relative basis, the best performing areas were tier 1 bank debt, which was volatile but outperformed the overall credit market, followed by insurance and general industrials; covered bonds underperformed.

Credit spreads

- Sterling credit bonds outperformed UK government bonds by 0.9%.
- Credit spreads narrowed sharply from 1.7% to 1.4% by mid quarter before widening as part of a more generic sell-off in risk assets.
- At the end of the quarter, the average credit yield was 1.6% above government bond yields, approximately 0.1% below the spread level prevailing at the end of March 2013.
- Over the quarter, most sectors saw a narrowing of credit spreads; covered bonds saw the greatest widening (12 basis points).

Financial sectors

- The performance of bank debt was again mixed; lower tier 2 bonds were weak although senior and tier 1 bank debt outperformed. Covered bonds underperformed.
- The insurance sector was relatively strong, recording a return of -1.0%.

Non-financial sectors

- Sector performance showed greater variance than in recent quarters. Telecoms and utilities underperformed, impacted by supply factors, whilst consumer bonds continued to lag, reflecting their relatively low credit spread premiums. General industrials showed an improvement, reflecting slightly more upbeat economic data. Secured debt mirrored general market movements.
- The underperformance of peripheral corporates seen in the previous quarter was partially reversed as sentiment improved following the formation of a “grand coalition” government in Italy and resolution to the Cypriot banking crisis.
- Corporate hybrid bond returns were varied, with more defensive names, such as EDF and National Grid, outperforming higher beta names.
- Issuance during the quarter was relatively subdued, with a bias towards the insurance and structured bond sectors. Issuance from the banking sector remained low, reflecting the ongoing support from central banks and the continued focus on reducing assets, thereby reducing funding needs.

Ratings and maturities

- Lower rated bonds again outperformed, reflecting the ongoing search for yield. BBB rated bonds gave a return of -2.4%. There was little difference in returns between other investment grade rating buckets, with all returning around -3.0%.
- BBB rated bond spreads narrowed, with the average spread falling by 0.2%; conversely, AAA rated bond performance was weaker, recording only a negligible fall in the average spread.
- By maturity the best performing areas were short dated bonds, reflecting their low duration; over 15 year bonds were the worst performers, returning -4.3% during the quarter.

Outlook

- Despite the weakness in credit spreads in June, we continue to believe that the pricing of credit bonds undervalues the asset class, relative to government bonds.
- The rise in government bond yields over the quarter has significantly reduced their over-valuation; this should underpin positive returns from sterling credit markets in the second half of the year.
- Government bond yields are unattractive and this will limit the absolute return that credit bonds can achieve in the medium term despite our view that credit spreads will fall over the next three years.

BOND MARKET REVIEW

Index linked bonds

Key points

- Index linked gilts returned -6.5% over the quarter.
- The strong demand for longer dated inflation protection, pushed longer dated breakeven (implied inflation) rates to their highest levels since the summer of 2011.
- Supply in the quarter was concentrated at the short to medium end of the market. This, combined with overseas selling of shorter dated bonds and pension fund buying at the long end of the market, led to the real yield curve flattening by over 0.8%.
- Commodity prices were generally lower over the quarter, with the Commodity Research Bureau index falling by 7%. The rate of the Retail Price Index (RPI) inflation fell slightly to 3.1%.
- Breakeven rates ended the quarter around 0.4% lower at the 10 year maturity point but around 0.1% higher at the long end.

Real yield and breakeven (implied) inflation curve moves

- The market traded to record low real yield levels in early April, with 10 year yields as low as -1.6%. Subsequently, however, real yields on bonds with maturities longer than 20 years rose by on average 0.3%, while shorter dated bond yields rose by up to 1.2%.
- Over the quarter, shorter dated breakeven rates fell by 0.4% to below 2.9%, reflecting lower commodity prices and a global sell-off in inflation protection led by the US TIPS (Treasury Inflation Protected Securities) market. However, longer dated bonds bucked the trend as a lack of supply and pension fund demand led to longer dated breakeven rates rising by 0.1% to over 3.5%, their highest level since the summer of 2011.

Variation of return across the UK market

- With demand for inflation assets concentrated at the long end of the market, and supply concentrated in medium dated bonds, the real yield curve flattened aggressively. The move was exacerbated by selling of shorter dated bonds by overseas investors, leading the yield curve to flatten by 0.8%.
- The FTSE Index Linked All Stock Index gave a return of -6.5% over the quarter, leaving the twelve month return at 2.4%. All index linked bonds posted negative returns over the quarter but longer dated bonds fared better as a consequence of the flattening of the yield curve. Longer dated bonds fell in the region of 7% whilst 10 year bonds fell by over 8%.

Overseas and credit index linked market

- Overseas bonds initially outperformed but, as a consequence of the US Federal Reserve's Federal Open Market Committee rhetoric and lower commodity prices, they ended the quarter underperforming the UK market by over 0.2%. The exception was Sweden which outperformed by over 0.3%.
- Non-government index linked bonds performed generally in line with index linked gilts.

Outlook

- UK real yields at the longer end of the market do not reflect long term economic fundamentals, with real yields remaining close to 0% whilst analysts' forecasts for real GDP are generally rising.
- The long end of the market has been supported by little supply and significant demand from UK pension funds. However, as we move into the third quarter, the UK's Debt Management Office have already announced that there will be two long dated syndications including the possibility of a super long issue. With over £7bn of supply expected we do not anticipate there to be sufficient demand at 0% real yields, particularly with long US real yields close to 1.3%.
- Given the supply schedule, we expect shorter dated bonds to outperform over the forthcoming quarter.
- Long breakeven rates of above 3.5% are now 0.1% above our year end target, and we expect them to fall as RPI inflation falls towards the end of the year.
- Overseas markets offer significantly better value, with real yields between 1% and 2% higher than the UK.
- Our real yield forecasts for 10 and 30 year index linked gilts at the end of 2013 are -0.5% and 0.4% respectively, significantly higher than at the end of 2012. We expect that inflation in the UK could remain sticky and will average around 2.5% over the longer term.

BOND MARKET REVIEW

Conventional government bonds

Key points

- Conventional gilts returned -3.8% during the quarter.
- The Bank of England Monetary Policy Committee left policy and quantitative easing unchanged at 0.5% and £375bn, respectively. The committee ended the quarter split, with some members calling for further quantitative easing, whilst others felt schemes such as the Funding for Lending Scheme were more effective.
- Consumer Price Index (CPI) inflation fell to 2.7% during the quarter, while quarter one gross domestic product (GDP) rose to 0.3%, resulting in 0.3% year on year growth. In addition, backward revisions to growth by the UK Office for National Statistics removed the 2012 double dip recession.
- The market digested a new ultra long syndication of a 2068 gilt. The Debt Management Office (DMO) announced that there will be two long dated index linked syndications including the possibility of a super long issue, which should weigh on long dated index linked gilts, weakening their performance versus conventional gilts.
- Medium dated gilts underperformed long and very short dated gilts on a risk adjusted basis as data improved and the US Federal Reserve (Fed) discussed ‘tapering’ the pace of bond purchases. Short index linked bonds underperformed during the quarter as global commodity prices fell, impacting global inflation expectations.
- Fitch downgraded the UK sovereign rating from AAA to AA+, resulting in gilts becoming a true AA+ issue, although this had limited impact on their relative value.
- A European Central Bank (ECB) rate cut and large scale stimulus by the Bank of Japan resulted in a strong performance of peripheral bond spreads during the quarter.

Yield curve moves over the quarter

- Yield curves in the UK steepened between 2 and 10 year maturities and flattened between 10 and 50 years as bond markets sold off during the quarter. The re-rating of interest rate expectations and unwinding of positions to benefit from low interest rates resulted in the 5 to 20 year area performing poorly.
- Issuance was dominated by medium dated conventional gilts. However, the DMO also issued £5bn of a new 2068 gilt.
- Conventional gilt issuance for the upcoming quarter will be largely spread across the curve. However, index linked issuance will be biased towards longer maturities. Additionally, the DMO announced two long syndications in July and September.
- Conventional gilt yields rose 0.5% at short maturities, 0.6% at medium maturities and 0.3% at long maturities.

Variation of returns across the UK market

- Overall, the UK government bond market gave a total return of -3.8% during the quarter, with short dated gilts returning -0.9%, medium dated gilts -4.1%, and long dated gilts -5.8%.

Overseas fixed interest markets

- Gilts performed in line with US government bonds, reflecting the better domestic data in both countries. Gilts underperformed Europe as the ECB cut rates and the economic situation remains subdued.
- Yields in core overseas markets rose over the quarter, while peripheral European countries outperformed. Spanish and Italian governments still managed to issue their debt relatively smoothly over the quarter.
- The Fed discussed the ‘tapering’ of bond purchases if economic data continued to improve, resulting in a large unwind of “lower for longer” trades and forcing 5 and 10 year bond yields significantly higher.

Outlook

- Our central case is for gilt yields to rise over the next twelve months. Government bonds markets already discount global recession and some chance of a disorderly outcome to the Euro crisis.
- We expect gilt market volatility to continue, given the continued high levels of global supply, sovereign debt fears and uncertainty over the impact of fiscal tightening on future growth.
- We believe interest rates will remain low by past standards as we expect inflation will not be a major threat over the next few years. As a result, the peak in base rates will be much lower than usual during the current economic cycle, resulting in a flatter yield curve.
- Our 31 December 2013 forecasts for five, ten and thirty year conventional gilt yields are 1.4%, 2.6% and 3.8% respectively; current yields are 1.4%, 2.4% and 3.6% respectively.

BOND MARKET REVIEW

Global high yield bonds

Key points

- The global high yield market returned -1.5% over the quarter, with quite varied monthly returns over this period (April 1.8%, May -0.5%, June -2.8%). May's negative return brought to an end eleven consecutive months of positive returns. Year to date returns are 1.0%.
- The best performing sectors were insurance (1.5%) and autos (0.4%). Real estate (-3.0%) and energy (-3.4%) were relative laggards.
- Global new issuance in the quarter was $116bn (78% up on the same period last year) with the year to date figure now standing at $256bn. The US and Europe account for approximately half and one quarter of this year's new issuance, respectively.
- The yield on the index ended the quarter up 0.9% at 6.7%, which puts the index yield back at levels not seen since November last year. At the end of the period, the average high yield credit spread was 5.5% above government bond yields, having widened 0.4% from the level prevailing at the end of the previous quarter. This spread is well above the all-time low of 2.4%, set in May 2007.

Regions

- The US and Canada returned -1.3% for the quarter, after being up 2.9% for the first five weeks of the period. The negative performance that occurred in the second half of the quarter was driven by concerns that the US Federal Reserve may scale back its stimulus efforts if economic data continued to improve.
- Europe returned 0.7% and was the surprise outperforming region. Risk assets were initially supported by the European Central Bank cutting interest rates in May. The outperformance versus the US was due to the fact that government yields in Europe did not rise by the same amount as US yields and that Europe has on average a shorter average duration.
- Emerging Markets was the weakest performing region, returning -4.7% in the quarter. This underperformance resulted from a combination of considerable investor outflows and the consequence of being relatively sensitive to movements in US treasury yields. Concerns over Chinese interbank lending also weighed on investor sentiment.

Monthly performance

- April witnessed a continuation of the rally in risk assets in the first quarter, with yields ending the month at all-time lows (5.4%, after 0.3% of spread tightening). This followed the announcement of a substantial Japanese quantitative easing programme and tightening of peripheral debt spreads. High yield returned 1.8% in April.
- In May, high yield began the month with a reasonably positive performance, only to suffer a sharp sell-off in the final week. This weakness was driven largely by concerns over US Federal Reserve 'tapering' of stimulus. High yield returned -0.5% in May.
- High yield returns in June suffered from persistent spread widening in conjunction with higher government yields, as uncertainty over the US Federal Reserve stimulus programme continued to unsettle risk assets. High yield returned -2.8% in June.

Ratings & maturities

- For the quarter, lower rated bonds broadly outperformed, reflecting the greater impact of higher government yields on the higher quality segments of the market.
- BB, B and CCC and lower rated bonds returned -1.6%, -1.7% and -0.4% respectively for the quarter. Yields at the end of the quarter now stand at 5.3%, 7.1% and 10.4%, respectively.
- Returns for the quarter were generally worse the longer the maturity of the asset. Global high yield returns were -0.1% for 0 to 3 years, -0.6% for 3 to 5 years, -1.6% for 5 to 7 years, -2.8% for 7 to 10 years and -2.1% for over 10 years.

Outlook

- Despite the challenging economic conditions, especially within the eurozone, we still expect the performance of emerging countries to underpin the growth in the global economy in the medium term.
- We continue to believe that global high yield bonds are attractive on a spread basis and overcompensate for both default risk and market volatility, while their level of income generation is also appealing.
- The current low growth and low rate environment provides a benign default climate, facilitating a virtuous cycle of lowering defaults as a result of refinancings. With average yields still lower than average coupons in global high yield, a substantial level of issuance is expected for refinancings in 2013.

BOND MARKET REVIEW

Overseas bonds

Key points

- The Bank of Japan expanded monetary policy with a large extension to their bond buying programme, but disappointed markets with growth reforms.
- The European Central Bank cut rates, as did a variety of smaller central banks around the world.
- US housing and labour market data show signs of stability.
- The 'tapering' of the US quantitative easing programme later this year was raised by Federal Reserve chairman, Ben Bernanke.
- After inconclusive Italian elections in February, a 'grand coalition' government was formed with Enrico Letta as Prime Minister and Giorgio Napolitano re-elected as President.
- European inflation was weak, while other regions were broadly in line with expectations.
- China money markets experienced a severe squeeze.

Yield curve moves over the quarter

- Yields rose in all major bond markets as the prospect of 'tapering' the US quantitative easing programme, currently a monthly $85bn of asset purchases, was considered by the market.
- While the move was triggered by the US authorities, yield rises were broadly consistent across the US, Germany and the UK.
- 10 year bond yields in the US, Germany and UK were 2.5%, 1.7% and 2.4% at the end of the period. The yield moves over the quarter were increases of 0.6%, 0.4% and 0.7%.
- Japanese government bonds were very volatile as the market struggled to efficiently price the change in the local bond buying programme. 10 year bonds ended the period at 0.9%, an increase of 0.3%.
- Breakeven (implied inflation) rates posted large declines as markets reassessed central bank reactions to potential inflation.
- A combination of rising conventional yields and falling inflation expectations led to large moves in real yields (the yield which index linked bond investors achieve over inflation and that which drives shorter term inflation linked bond prices).
- At the end of the quarter, real yields in the US, Germany and the UK were 0.5%, 0.2% and -0.4%, reflecting increases of 1.1%, 0.7% and 1.1% over the quarter. Accompanying breakeven rates were 2.0%, 1.6% and 2.9%.
- Both nominal and real yield curves flattened over the period with 30 year bonds rising in yield by less than 10 year bonds.

Currency markets

- Over the quarter, sterling strengthened against the basket of currencies in the indices.
- A decline in the value of sterling against the euro was more than offset by an increase in value against the Japanese yen.

Outlook

- We expect that global economic growth will be subdued over the near term although, in our view, there will be no significant double dip recession.
- Events in Europe will continue to dominate market sentiment. Given the historic political capital invested in the region and the extremely negative consequences of a breakup, we expect the eurozone to survive but the transition to greater fiscal and political unity to be volatile. Near term however, the situation remains unpredictable.
- Given the low level of real yields, we expect a moderate rise from current levels though this will be limited by anaemic global growth prospects and a broadly supportive backdrop for bonds.
- In the wake of a very deep recession, we do not see an immediate period of sustained inflation, unless economic growth turns out to be much faster than we expect. In the medium term, however, we see upside risks to inflation given the large amount of recent monetary and fiscal stimulus.
- We expect no change in base rates from major central banks over the near term and, when they do rise, we expect them to plateau at a very low level compared with past standards.

SPECIAL TOPIC

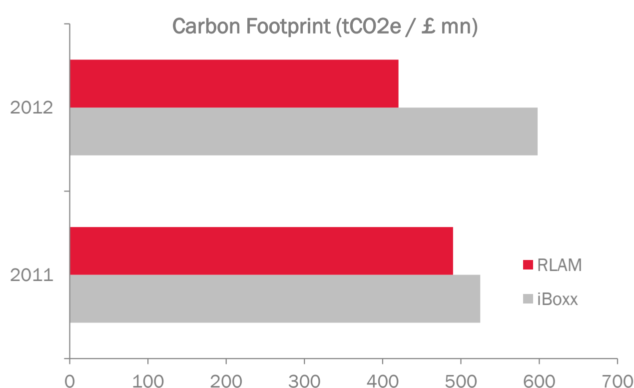
Environmental, social & governance risks and credit investment

Ready access to debt funding has led to the return of leveraged private equity-led corporate acquisitions. Whilst equity investors see a healthy valuation uplift, bondholder risk increases, misaligning stakeholder interests. Understanding this 'governance conundrum' of fixed income investing is a key starting point from which bondholders can enhance control over the companies they lend to. Although environmental, social & governance (ESG) management is a relatively well understood concept in equity markets, how can we integrate an evaluation of ESG risks into fixed income investment?

The governance conundrum: although debt investors are important stakeholders, they are not owners of companies and have no direct influence over management; they enjoy a more senior claim over a company's assets, but a subordinated control position. Consequently, they often focus more on market liquidity to trade out of positions if their view changes, whilst relying on equity investors to act as guardians of their conscience in the interim. Unfortunately, as leveraged buyouts demonstrate, the theoretical alignment of interests between equity and debt holders is not necessarily mirrored by economic reality, given pressure on management to increase debt levels to boost equity returns and hit short term performance incentives. The divergence in interests may encompass different providers of debt funding. Banks tend to lend on a short-term bilateral and heavily covenanted basis. Should a company's financial situation deteriorate, they are positioned to extract improved lending economics to the detriment of longer term, non-covenanted providers of funding. In periods of distress, not only do unsecured bondholders face the risk of increased default, they can be further damaged by banks moving ahead of them in the company's capital structure, significantly reducing recovery prospects. Against this reality, it is remiss of bond investors to abdicate their corporate governance responsibility, especially as banks are now pulling liquidity away from secondary market trading.

Our governance solution has three components. First is pre-emptive control. Maximising this is the most tangible way of improving our position as stakeholders. The majority of benchmark corporate bonds are unsecured and lightly covenanted, with transitory protections such as liquidity and ratings more highly regarded by the wider investment community. We construct our portfolios with much larger exposures to secured bonds with protective covenants, ring-fencing investments against unforeseen and unquantifiable future liabilities. The fact that the market does not value more objective credit enhancements as highly provides the opportunity to construct more secure portfolios without compromising yield. Second, we adopt a longer term investment horizon. We have always considered ourselves as lenders to companies rather than traders of corporate bonds. This, coupled with our mutual ownership structure, affords us a longer term perspective. Third is targeted engagement. We exert further influence over companies by focusing engagement where we have the greatest potential traction, such as within social housing, building societies and securitisations. As members of the Association of British Insurers, we also have a forum to co-ordinate more disparate bondholder groups. Our approach is a pragmatic and realistic solution to the corporate governance conundrum, where understanding the practicalities of governance and capital structure is central to mitigating risk.

The barriers to governance and engagement imply that the potential for bond investors to play an active role in the management of other less traditional factors, such as environmental and social risks, is limited. Where thinking has developed, it has tended to follow an equity market prescription, often resulting in a disjointed interaction between managers' equity and fixed income businesses. However, bond investors start from a better position than shareholders, and not simply because equity bears the first loss. Corporate bond indices should exhibit higher 'sustainability' than their equity equivalents due to lower weightings in heavy industrials and a more general skew towards global large cap companies. Early conclusions from third party providers of ESG research (such as EIRiS' sustainability scoring system) appear to support this.



Source: Trucost, March 2012

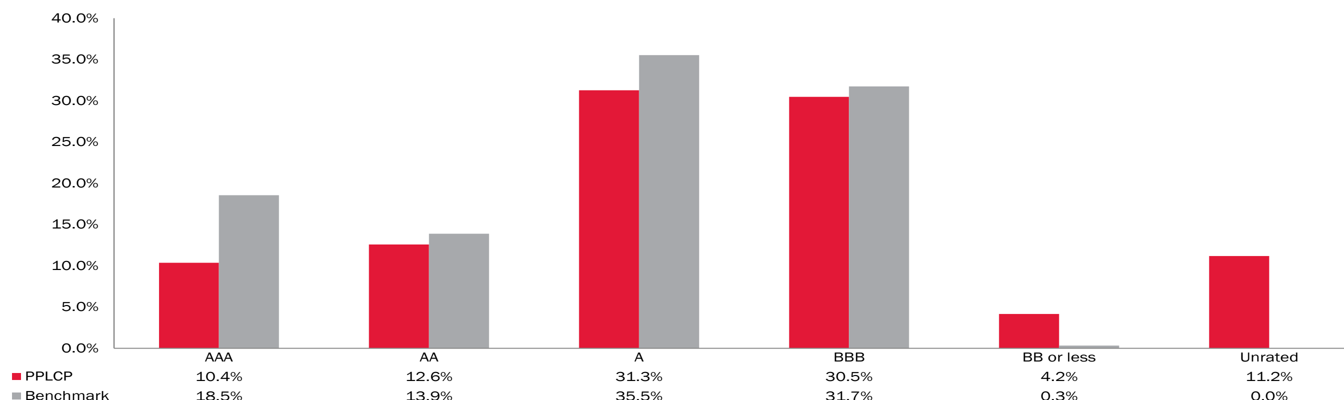
We have developed a strategy for a specific client that leverages off the specialist skills of third party ESG experts. The simple philosophy is that companies with the largest environmental impact must evidence the most effective mitigation through reporting, management systems and processes, and demonstrable environmental improvement. As well as strong financial returns and improvements in environmental mitigation, this fund, which is largely representative of the majority of our credit funds, is also able to demonstrate a markedly better environmental performance against a typical corporate bond index. Both this fund and the Royal London Ethical Bond Fund are fully diversified and have similar sector exposures to our other corporate bond funds, including a high level of secured assets, as well as sharing similar duration and yield premium characteristics. In delivering this strategy we are therefore not compromising our long-established approach.

There is still much to do to improve the role of bondholders in a wider ESG context. However, recognising the structural hurdles within corporate bond markets has allowed us to develop a credible and realistic approach, with a strong emphasis on redressing bondholders' traditionally weak control. Our first line of defence remains portfolio structure; diversification to minimise specific risk and a high proportion of secured assets to ring-fence our investments from unforeseen or unquantifiable liabilities. In addition, we have a longer term investment outlook and get closest to companies where we can have the greatest influence. For clients with specific ESG requirements, we can deliver a tailored overlay strategy that does not compromise the key cornerstones of our investment philosophy.

PORTFOLIO ANALYSIS

Credit rating profile

Credit ratings



	AAA	AA	A	BBB	BB or less	Unrated
PPLCP	10.4%	12.6%	31.3%	30.5%	4.2%	11.2%
Benchmark	18.5%	13.9%	35.5%	31.7%	0.3%	0.0%

Source: rlam. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio.

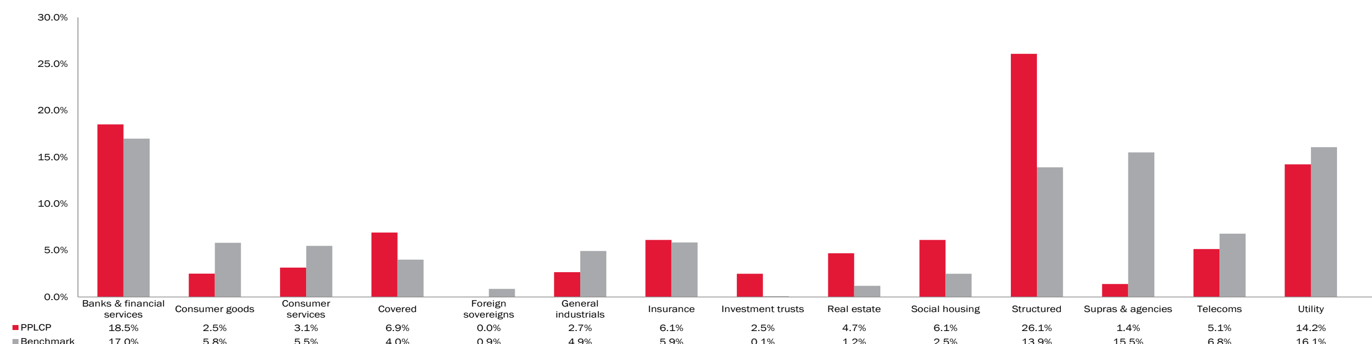
The Manager determines the credit rating of the bonds by taking the S&P rating first, if unavailable he uses the Moody's rating; otherwise the Fitch rating is used.

- From a rating perspective, the broad structure of the fund was maintained.
- We maintained a bias towards A and BBB rated bonds, believing these lower rated bonds offered better value; with BBB rated bonds outperforming during the quarter, the credit rating profile of the portfolio was beneficial.).

PORTFOLIO ANALYSIS

Sector profile

Sectors



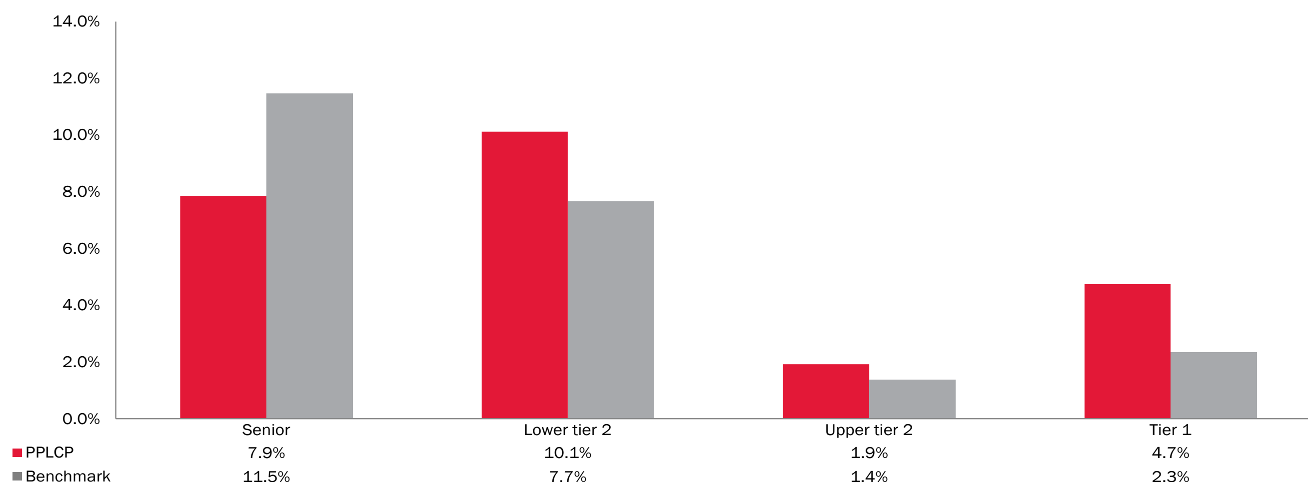
Source: rlam. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio.

- A significant underweight of supranationals and a bias towards sectors with large asset backing (structured, investment trusts and real estate) continued to be the main features of the portfolio.
- Within financials, we reduced the banking sector, while participation in attractively priced new issues from Scottish Widows and Liverpool Victoria led to increased exposure to the insurance sector.

PORTFOLIO ANALYSIS

Bank & insurance tiering profile

Financial holdings



	Senior	Lower tier 2	Upper tier 2	Tier 1
PPLCP	7.9%	10.1%	1.9%	4.7%
Benchmark	11.5%	7.7%	1.4%	2.3%

Source: rlam. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio.

- We maintained an overweight to both the banking and insurance sectors over the period which was beneficial to performance.
- The underweight to senior bonds was a detractor for performance, as this part of the capital structure rebounded strongly from last quarter's marked underperformance following the Cyprus bail-in. We continue to be underweight senior bonds, preferring the covered bond sector which underperformed during the quarter.
- Despite volatility towards the end of the quarter, subordinated financials were the the strongest performers during the period, supporting overall fund performance.

CREDIT RATINGS

Changes

Downgrades

The table below details the sterling credit bonds downgraded to sub-investment grade by at least one agency during the quarter*:

Issue	S&P	Moody's	Fitch	RLAM composite
Co-operative Bank 5.875% 2033	-	Ca	CC-	CC

Source: rlam.

*We have not included bonds that, for example, were classified as sub-investment grade by at least one agency last quarter and have now been downgraded by a second or third agency.

Upgrades

The table below details the sterling credit bonds upgraded to investment grade by at least one agency during the quarter so that those bonds are rated investment grade by each agency that rates them:

Issue	S&P	Moody's	Fitch	RLAM composite
-	-	-	-	-

Source: rlam.

There were no upgrades this quarter

The Manager determines the RLAM composite credit rating of the bond by taking the S&P rating first, if unavailable he uses the Moody's rating; otherwise the Fitch rating is used.

CREDIT RATINGS

Internal bond ratings

Unrated bonds

Issuer	RLAM internal rating	Fund weighting
Annes Gate Property 5.661% 30/06/2031	bbb+	0.9%
Scottish Investment Trust 5.75% 17/04/2030	aa	0.8%
Law Debenture 6.125% 12/10/2034	aa+	0.8%
First Hydro Finance 9% 31/07/2021	bbb	0.7%
Home Group 0% 11/05/2027	a	0.7%
Grosvenor UK Finance 6.5% 29/09/2026	a+	0.7%
Unifund 5.32% 07/12/2047	a	0.6%
Delamare Finance 6.067% 19/02/2029	bbb+	0.6%
British Land 5.357% 31/03/2028	a+	0.6%
Peel Holdings 8.375% 30/04/2040 Step	bbb+	0.5%
Intu Debenture 5.562% 31/12/2027	a-	0.5%
British Assets Trust 6.25% 10/09/2031	aa	0.5%
Aa Bond Co Ltd 6.269% 02/07/2043	nr	0.5%
Merchants Trust 5.875% 20/12/2029	aa	0.4%
Great Portland Estates 5.625% 31/01/2029	a	0.4%
South West Water 5.875% 16/07/2040	a-	0.4%
Bld Property 9.125% 31/12/2020	a-	0.4%
Resolution 6.5864% Vrn Perp	b	0.2%
Letinvest 11.25% 03/03/2012	bb	0.1%

INVESTMENT OUTLOOK

Key points

- Our central case assumes 1.2% gross domestic product (GDP) growth in the UK in 2013, continued recession in the Euro area and modest growth in the US.
- UK inflation to remain above target over the next 12 months.
- UK interest rates to remain on hold until late 2015 at the earliest and remain low relative to inflation.
- We remain positive on credit bonds relative to conventional and index linked government bonds.

Global economic growth prospects

- Our central assumption remains that the acute nature of the 2007/8 financial crisis, and in particular the preceding large rise in debt levels, means that recovery from it will be lengthy and volatile. Our base case assumes a modest reacceleration of global activity over the second half of 2013, thanks to some pick up in the US and Japanese economies, combined with a stabilisation in eurozone GDP.
- Economic news since March has been largely in line with our existing expectations but with caveats; growth in the UK and Japan is a little stronger than we had assumed, and the downside risks to our base case China forecast have increased. Our 2013 GDP forecasts for the US and eurozone are unchanged, with the US forecast already assuming some degree of fiscal tightening. Our forecast for Japan has been raised, while that for China has been reduced.
- Stronger business survey data during the second quarter have led to a small upgrade in our base case 2013 UK growth forecast; expansion is expected to remain slow relative to previous recoveries. UK growth resumed in the first quarter of 2013, and we expect a modest pick-up in GDP over the course of this year (1.2%) and next (1.5%).
- Structural imbalances, including excessive debt levels in the household and public sectors, still need to be worked off, and consumer spending (which accounts for the largest share of GDP) is constrained by weak real income growth. The UK is 40% of the way through planned fiscal tightening, with most tax rises having taken effect but only 30% of planned spending cuts implemented.
- The potency of the Euro crisis for market sentiment has waned over the past 12 months as the European Central Bank's Outright Monetary Transactions policy has reduced the immediate threat of countries exiting the Euro area. However, the underlying problems remain unsolved, and a return to a cycle of crisis summits remains possible, although not part of our base case.

Inflation and growth – how will they impact interest rates?

- UK Consumer Price Index (CPI) inflation is likely to remain above target over the next 12 to 18 months, reflecting sterling's depreciation and a persistent contribution from administered and regulated prices, such as university tuition fees and 'green' energy taxes; demand and supply balance drive the longer term inflation outlook. There is little evidence of rapid wage growth impacting inflation, long term; this will more likely come from the scale of the UK monetary policy response, but will be dependent on how conditions are tightened.
- Expect rates to remain on hold in the US and UK through 2015, and any future rise in developed market short rates to be modest, thanks to ongoing fiscal restraint and banking sector fragility.

Our views on the outlook for the main bond asset classes

- Expect higher macro volatility based on inflation/deflation/stagflation concerns, suggesting lower risk asset valuations than pre 2008/9. Markets are caught between the opposing forces of a fragile economic background and ample liquidity.
- While government bonds are pricing in poor economic news, with investors paying dearly for very low real returns, a stable interest rate view means a dramatic sell-off in government bond markets over the next 12 months is not our central forecast. Credit remains the best (least worst) yield prospect under a low growth and inflation scenario, given valuations are not stretched and government bond yields are still low. However, this relies on corporates not re-leveraging, or prolonged low growth depleting current financial strength.
- Strong company balance sheets and central bank liquidity, forcing investors to look for yield, underpin credit valuations. We expect returns from investment grade corporate bonds to exceed government bonds by at least 2.5% over 2013.

The key views within the portfolio

- A significant underweight in supranational bonds as we expect credit bonds to outperform.
- Duration is similar to benchmark; we expect higher UK government bond yields in the second half of 2013 offset by lower credit spreads.
- A bias towards asset backed securities, an area that we believe still offers the best risk/return characteristics.
- An overweight position in financial debt where we believe yields are attractive.

CORPORATE GOVERNANCE & COMPLIANCE

MiFID (Markets in Financial Instruments Directive)

Pursuant to the FCA rules and based on information that we hold about you, we have classified you a 'Professional Client'.

Whistleblowing requirements of the Pensions Act

- We confirm that we have not made any reports to the Pensions Regulator during the quarter, as we do not believe there has been a breach of law relevant to the administration of the scheme.

The UK Stewardship Code & Royal London Asset Management

- RLAM is supportive of the Stewardship Code and we intend to comply with the Code and in particular the seven principles contained in the document. Our compliance with the code will involve reporting on our activities in relation to the principles, and monitoring of and interaction with our investee companies in pursuit of our clients' best interests.
- Our underlying belief is that management are appointed by the shareholders to manage the business in the best interest of shareholders over time. While engagement is largely from an equity investor's perspective given that in most instances there is a limited amount of leverage that a bond holder can exercise over the issuing company, our own experience is that we are becoming more involved in corporate bond restructurings and that these in many instances involve a bondholder vote. We will ensure that we approach such decisions in the same way we would on an equity issue in aiming to support management where appropriate but always seeking to enhance value on behalf of our underlying clients.
- We intend to continue publicly disclosing our voting record which covers all of the votes available to us on all our accounts. We subscribe to the IVIS voting service provided by the Association of British Insurers to help us in this process.
- All enquiries regarding our activities with respect to engagement should be directed in the first instance to the RLAM Chief Investment Officer.

Our voting record and details of how RLAM approaches the stewardship of the securities we hold on behalf of our clients are on our website at the following location: www.rlam.co.uk

Our relationships with our broker counterparties

- At RLAM, we supported the recommendations in the original Myners Report and the supplementary review of transaction costs.
- We currently deal through approximately 50 brokers globally; a mixture of global firms and regional specialists which enables us to access different information flows and therefore, enhances the overall investment process.
- We undertake a comprehensive broker rating/review process where all brokers used are scored for the quality and utility of their research, dealing abilities, administrative efficiency, accuracy and sales advice. To get a full picture, we involve fund managers, dealers and any comment from the back office. We do not have soft commission arrangements with any counterparties.

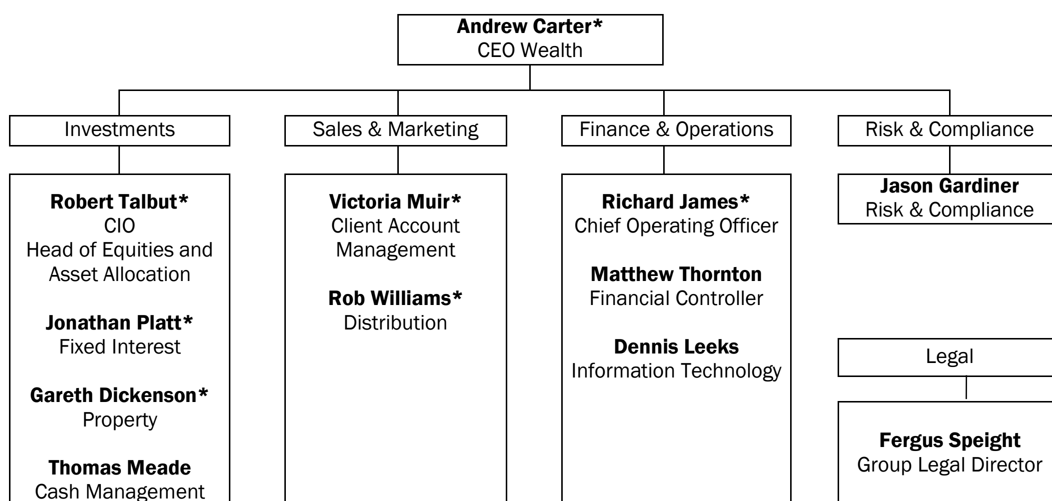
YOUR RLAM TEAM

Your fund managers

Jonathan Platt
Head of Fixed Interest

Paul Rayner
Head of Government Bonds

RLAM senior management team



*Directors of RLAM

Client Account Management team changes

Lynsey Mead, Client Account Manager, will be going on maternity leave at the end of August. Sophie Niwaz joined RLAM in June in order to take over the day-to-day client care for Lynsey's clients. Sophie joins us from RBC Investor Services, where she was a Client Manager. Prior to this Sophie worked at Deutsche Bank in relationship management, Nomura and Merrill Lynch in sales trading and started off her career at UBS. Sophie holds a BSc in Development Economics and a Graduate Diploma in Law.

Portfolio Risk team changes

Carola Lawton-Browne, Portfolio Risk Manager, is leaving RLAM in July to relocate to her native Sweden. Recruitment for a replacement is at an advanced stage; a formal offer was made to a preferred candidate in early July, with a scheduled start date, subject to completion of necessary paperwork, of early September.

GLOSSARY

ABS – Asset backed securities – Debt secured against assets of the issuer.

Amortisation – Incremental repayment of a bond over its lifetime.

Attribution – The measurement of a fund's return versus the underlying benchmark return that breaks up the active performance into component parts:

- **Stock selection** – Performance attributed to stock selection.
- **Yield curve** – Performance attributed to positioning on the yield curve.
- **Duration** – Performance attributed to relative duration of the portfolio versus that of the benchmark.
- **Asset allocation** – Performance attributed to asset allocation between fixed interest gilts and credit bonds.

Basel – The Basel Committee on Banking Supervision provides a forum for regular global co-operation on banking supervisory matters.

Benchmark – An index or other market measurement that is used by an investment manager as a standard against which to assess the risk and performance of a portfolio.

Book cost – A measure of the historical cost of a bond or a portfolio of bonds represented as a clean value. It is calculated as the product of the number of bonds held and the average price paid. It remains unchanged regardless of movements in market price. If the price paid is the same as the face value of the bond, book cost will be the same as the nominal value.

Breakevens – The level of inflation required to make the return on index linked bonds equal to return on conventional bonds of similar maturity.

Capital cover – The degree to which debt is covered by the assets of the issuer.

Certificate of deposit (CD) – A certificate of deposit is a negotiable receipt issued by a deposit taking institution in respect of a specified sum of money deposited with that institution at a fixed rate of interest, with an undertaking to repay to the bearer of the certificate at a specified date the sum deposited with interest outstanding. The term of a CD generally ranges from one month to five years – with annual interest payments for those that are issued for longer than a year.

CDO – Collateralized debt obligations – A relatively small subset of the wider ABS market, CDOs are securitisations of a pool of debt receivables (that are not secured on tangible property). Typically, these securities are divided into different tranches: senior tranches, mezzanine tranches and equity tranches. Losses are applied based on the seniority of the tranche, with the most junior tranche absorbing losses first. The bonds are tranched to provide investors with different levels of seniority and credit rating. Variations include collateralised loan obligations (CLOs) and collateralised synthetic obligations (CSOs), where the underlying pools of assets are corporate loans and credit default swaps (that are not secured on tangible property).

Consumer price index – An index number calculated as the weighted average price of consumer goods and services.

Coupon – Interest paid by the bond issuer expressed as a percentage of the face value of a bond; typically paid annually or semi-annually.

Covenant – Legal rules found in bond documentation that place restrictions on the issuer.

Covered bond – Senior bonds issued by banks and collateralised by a high quality pool of residential mortgage assets.

CDS – Credit default swaps – Insurance purchased to protect against the default of a bond. In the event of default, the CDS buyer receives the face value of the bond in return for delivering the bond to the provider of protection.

Credit rating – A rating agency (Moody's, S&P, Fitch) measure of the credit worthiness of a bond issuer – investment grade credit ratings range from AAA to BBB with BB and below referred to as sub-investment grade (sometimes known as 'junk bonds' or 'high yield'). In general, for investment grade credits the rating agency rates only on the probability of default and does not take into account the potential recovery prospects of the bond.

Credit spread – Extra yield offered to compensate the holder of a credit bond versus an underlying risk free bond of similar maturity. Specifically, the holder requires compensation for the expected loss on default, reflecting a combination of probability of default and recovery rate on default. Compensation may also be required for extra market risk and liquidity risk.

Cyclicals – Bonds/stocks that are sensitive to the economic cycle.

Default – Failure of a bond issuer to pay the coupon, or principal when required, on a debt instrument.

Duration – A measure of the sensitivity of a bond's price to shifts in interest rate, specifically calculated as the weighted average number of years to each of a bond's cash flows.

ECN – Enhanced capital notes. ECN is a subordinated debt instrument issued by Lloyds Banking Group as part of the 2009 capital restructuring. The bonds were issued in exchange for Lloyd's existing upper tier 2 and tier 1 bonds and are lower tier 2 in the capital structure. Although the regulator also classifies these instruments as LT2, for the purposes of stress testing they are included in the equity capital base of the bank. Coupon payments of ECNs are not deferrable and the bonds are dated. However, should the core tier 1 capital ratio fall below 5%, the ECNs will mandatorily convert into equity.

European Financial Stability Facility (EFSF) – Agreed in May 2010 by EU member states, the temporary program can issue bonds or other debt instruments to raise funds needed to provide financial assistance to eurozone states in economic difficulty. The EFSF is financed by members of the eurozone.

European Stability Mechanism (ESM) – A permanent rescue fund program designed to replace the temporary EFSF; the fund commenced operations in October 2012.

GLOSSARY

FRN – Floating Rate Notes – a bond with a variable coupon. Typically, coupons of sterling FRNs are referenced against 3 month LIBOR and are reset quarterly.

Funding for Lending Scheme (FLS) – Launched in July 2012, the scheme is designed to lower bank funding rates by allowing banks and building societies to borrow directly from the Bank of England for up to 4 years. Those that increase lending to UK households and businesses will be able to borrow more in the FLS, and do so at lower cost than those that scale back lending.

Futures – A contract between two parties where one agrees to buy and the other to sell an underlying instrument at a future date at a price agreed at the start of the contract.

FX – Foreign exchange.

Gearing – The level of debt to equity.

Interest cover – The degree to which interest expense is covered by the profit of the issuer.

Interbank rate – Lending rate between banks in the wholesale money market; LIBOR stands for London InterBank Offered Rate.

Internal rating – RLAM's assessment of the creditworthiness of a bond; crucially this takes account not only of the probability of default of a company but also the likely recovery rate on default.

Investment restrictions – Restrictions imposed on the portfolio managers by clients as outlined in the Investment Management Agreement (IMA).

Liability management exercise (LME) – Under certain circumstances, companies can offer to buy back or swap their bonds at a discount to par value in order to boost capital reserves. This process has been used most extensively in the financial services sector and, typically, these exercises have been undertaken at premiums to prevailing market prices.

Loan to value (LTV) – Expressed as a %, the value of the loan to the value of the assets backing the loan.

LDI – Liability driven investment – Investing in order to match liability cash flows with asset cash flows. This is often achieved using derivatives products to overlay a bond portfolio in order to control duration.

LTRO – Long Term Repo Operation – European Central Bank debt facility to provide 3 year term funding to European financial institutions.

Market value – Market value reflects the value of a security after issuance as influenced by movements in underlying gilt prices and the market's assessment of credit risk. The value of bonds held in the portfolio reflects this market value. Although borrowers typically pay coupons on an annual or semi-annual basis, different treatment of the accrual of coupon payments results in two market value definitions.

> **Market value clean** – Accrued interest is calculated separately and not reflected in the clean market value.
>
> **Market value dirty** – The market value includes accrued interest.

Maturity – Final payment date of a bond, requiring the borrower to repay the bond.

MBS – Mortgage backed securities – An asset backed security (ABS) where cash flows are backed by the principal and interest payments of mortgage loans. RMBS relates to residential MBS. CMBS refers to commercial MBS.

Monoline insurance company – The original business model of the monoline insurers was to provide credit-wrapping (credit insurance) of lower rated bonds by guaranteeing the payment of coupon and principal of the underlying bonds in return for premium payments. This sector had been characterised by decades of unbroken profitability and the consistent maintenance of AAA credit ratings, however, over the past ten years, the focus of the sector shifted from the US municipal market to the credit-wrapping of structured products, such as sub-prime RMBS and CDOs. As losses in these instruments have increased in recent years, concerns have arisen regarding the adequacy of the insurers' claims paying reserves. This has resulted in material rating downgrades within the sector. Following these downgrades, a large majority of credit wrapped bonds are now rated according to the underlying credit quality of the issue rather than the monoline's rating. The main monoline insurance companies are AMBAC, MBIA, FSA and FGIC.

Nominal value – Also known as the face value. It refers to the price of a security when issued. For fixed income assets, nominal value is the product of the number of bonds issued and face value per bond (usually denoted by 1,000). Within the portfolio valuation, nominal value represents a client's holding in a bond expressed at face value.

Operation Twist – The name given to the Federal Reserve's monetary policy designed to lower long term interest rates by selling short-term Treasury bonds in its portfolio and buying longer-term Treasury bonds.

Outright Monetary Transactions (OMT) – An unlimited bond-buying scheme aimed at cutting the borrowing cost of debt-burdened eurozone members by buying their short-dated bonds, but only after countries have requested a bailout from the European Central Bank. The scheme was announced in September 2012.

PFI – Private finance initiative – Projects that involve the provision of assets for the public sector by private companies. For instance, the Octagon PFI involves the design, financing, construction and operation of Norfolk & Norwich Hospital by a private company for the Norfolk & Norwich NHS Trust.

Quantitative easing – In March 2009, the Bank of England (BoE) announced its intention to purchase UK government bonds (primarily medium dated UK government bonds) by creating new money (effectively printing money, but electronically). The process was subsequently paused by the BoE during quarter 1 2010 and later restarted in early quarter 4 2011. This process of purchasing assets through "printing" money is called quantitative easing (QE).

Redemption yield – The annual interest rate on a bond including any capital gain or loss if it were held to redemption and assuming that all coupon and principal payments are made. If the coupon rate exceeds the redemption yield, then the bond will experience capital loss as it approaches maturity and vice versa.

GLOSSARY

Sale & leaseback – A process by which a company sells an asset then leases it back.

Securities Market Program (SMP) – A monetary policy tool aimed at providing market liquidity by allowing the European Central Bank to purchase distressed government bonds of peripheral European countries.

Seniority/subordination – Represents a bond holder's relative claim on the assets of an issuer before or after default.

Structured bonds – Bonds issued by a legally separate structure and secured on assets. The structure is often tranched, with different credit ratings for different levels of seniority. The process of issuing structured bonds is often referred to as securitisation.

Sub-investment grade – A credit rating that is below BBB-, also referred to as high yield or junk.

Sub-prime – Riskier mortgage lending to non-prime borrowers.

Supranationals – International non-government agencies/institutions such as the European Investment Bank and the World Bank.

Swaps – A derivative product representing an agreement to exchange one series of cash flows for another.

- **Interest rate swaps** – Exchange fixed cash flows for floating cash flows or vice versa.
- **Inflation swaps** – Exchange inflation index linked cash flows for conventional cash flows or vice versa.

Swaption – This derivative gives the holder the option (a right but not an obligation) to enter into an underlying swap.

Tracking error – A measure of the variability of active return, which is the difference between actual return and benchmark return.

Underwriting – The process by which an underwriter guarantees the new issue of securities (equity or bond).

Unrated bonds – Bonds that are not rated by any of the rating agencies; traditionally, unrated bonds benefit from security over the assets of the issuer. Unrated bonds are assigned an internal rating by RLAM.

Yield – Interest rate earned on a bond, expressed as an annual percentage.

Yield curve – The relation between the interest rate and the time to maturity of a bond.

Good thinking. Well applied.

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Portfolio Valuation

As at 30 June 2013

Dorset County Pension Fund

	Holding	Asset Description	Market Price (Bid £)	Book Cost Capital (£)	Market Cap. Value (£)	Accrued Inc. Value (£)	Market Value (£)	Days Accrued	Market Value %
Funds Held									
	110,319,467	RLPPC Over 5 Year Corp Bond Pen Fd	1.66153	120,568,793.04	183,299,103.90	0.00	183,299,103.90	0	100.0
			Funds Held total	**120,568,793.04**	**183,299,103.90**	**0.00**	**183,299,103.90**		**100.0**
			Grand total	**120,568,793.04**	**183,299,103.90**	**0.00**	**183,299,103.90**		**100.0**

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Trading Statement

For period 01 April 2013 to 30 June 2013

Dorset County Pension Fund

Acquisitions

Funds Held

Trade Date	Transaction Type	Nominal	Security	Price (£)	Book Cost (£)
08 Apr 2013	Acquisition Rebate	60,980.36	RLPPC Over 5 Year Corp Bond Pen Fd	1.77	107,632.17
				Funds Held total	**107,632.17**
				Acquisitions total	**107,632.17**