Quarterly Report 30 September 2013

Dorset County Pension Fund

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YOUR PORTFOLIO

Fund performance objective

The fund objective is to outperform the benchmark by 0.8% per annum gross of the standard management fees.

Fund asset allocation and benchmark ranges

Fund and benchmark index	Fund allocation (%)
RLPPC Over Five Year Corporate Bond Fund Benchmark: iBoxx Sterling Non-Gilt Over 5 Year Index.	100.0

Portfolio value

	Portfolio total (£m)
30 September 2013	188.68
30 June 2013	183.30
Change over quarter	5.38
Net cash inflow (outflow)	0.00

EXECUTIVE SUMMARY

Performance

- The fund gave a gross return of 2.94% over the quarter, compared with a benchmark return of 2.64%, bringing performance year to date of the fund and its benchmark to 2.14% and 0.47% respectively.
- Credit sector and stock selection were the main drivers of performance.

The economy and bond markets

- Recent data indicated some improvement in the growth prospects in some Advanced Economies, offset by weakness in some Emerging Markets. UK growth forecasts moved higher in response to stronger gross domestic product (GDP) and business survey data; early estimates suggest that UK GDP increased by almost 1% in the first half of 2013. UK Consumer Price Index (CPI) inflation was 2.7% in August. The Bank of England left monetary policy unchanged and adopted formal forward rate guidance.
- Despite widespread speculation that the US Federal Reserve would begin reducing the pace of its asset purchase programme, the expected change was not introduced, following weaker data. Euro-area GDP rose by 0.3% in the second quarter and business surveys suggest a further expansion in the third quarter. In Asia, China's GDP growth rate fell 0.2% in the second quarter to 7.5% year-on-year (yoy), while Japanese output rose by 0.6%.
- Conventional gilts returned 0.47% over the third quarter, the 10 year yield rising to 2.7%. Short and medium dated gilts underperformed long dated gilts. Issuance was spread between 5, 10 and 30 years. Index linked gilts returned 0.59% as the market digested two long dated index linked syndications, including a £5bn 2068 maturity. Short dated index linked bonds outperformed longer maturities as the 2013 index linked gilt redeemed, leading to demand for shorter dated bonds. Developments in Syria drove oil prices higher over the quarter. Breakeven inflation rates ended the quarter around 0.1% higher at the 10 year maturity point but unchanged at the long end. Sterling credit bonds returned 2.18%, outperforming government bonds. Returns in all sectors were positive, with the best performing areas banks, insurance and utilities. Supranational bonds were the notable laggard.

Investment outlook

- Although having risen from record lows, we expect a further moderate rise in gilt yields; a dramatic sell-off in government bond markets over the next 12 months is not our central forecast. UK real yields at the longer end of the market do not reflect long term economic fundamentals, with real yields remaining close to zero whilst analysts' forecasts for real GDP are generally rising. We believe that the pricing of credit bonds undervalues the asset class. We expect returns from investment grade corporate bonds to exceed government bonds by at least 1.5% p.a. over the next three years.

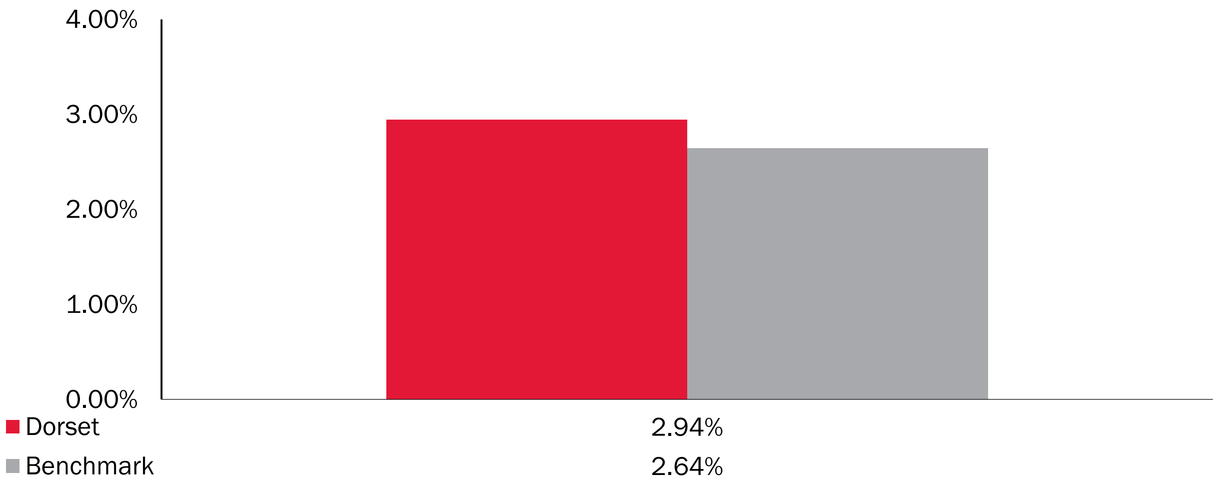
FUND PERFORMANCE

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:

Dorset Performance

	Dorset (gross) (%)	Benchmark (%)	Relative (%)
Q3 2013	**2.94**	**2.64**	**0.30**
Year to date	2.14	0.47	1.67
Rolling 12 months	5.55	2.73	2.82
3 years p.a.	10.88	10.86	0.02
5 years p.a.	12.47	10.72	1.75
Since inception 02.07.07p.a.	9.37	10.09	-0.72

Quarterly performance



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

RLPPC UK OVER 5 YEAR CORPORATE BOND FUND

Quarter 3 2013

Asset split

	Fund (%)	Benchmark[1] (%)
Conventional credit bonds[2]	100.0	99.2
Index linked credit bonds	0.0	0.0
Sterling conventional gilts	0.0	0.0
Sterling index linked gilts	0.0	0.0
Foreign conventional sovereign	0.0	0.8
Foreign index linked sovereign	0.0	0.0
Derivatives	0.0	0.0

Fund data

	Fund	Benchmark[1]
Duration	9.9 years	9.7 years
Gross redemption yield[3]	4.74%	4.15%
No. of stocks	360	724
Fund size	£189.2m	
Benchmark /objective change date		02.07.2012

Launch date: 02.07.2007
1 Benchmark: iBoxx Sterling Non-Gilt Over 5 Year Index.
2 Conventional credit bond allocation includes exposure to non-sterling credit bonds and CDs, where applicable.
3 The gross redemption yield is calculated on a weighted average basis.
Figures in relation to the asset spilt table exclude the impact of cash where held.

Fund Performance

	Fund (%)	Benchmark[1] (%)	Relative (%)
Q3 2013	**2.86**	**2.64**	**0.22**
Year to date	1.92	0.47	1.45
Rolling 12 months	5.31	2.73	2.58
Since inception p.a. (acc) 02/07/2012[2]	10.27	7.58	2.69

1 Benchmark: iBoxx Sterling Non-Gilt Over 5 Year Index.
2 The fund launched 02.07.2007 but its benchmark and objective changed on 02.02.2012. Performance prior to 02.02.2012 has therefore been omitted. If you require performance prior to this change, please contact your client service manager.

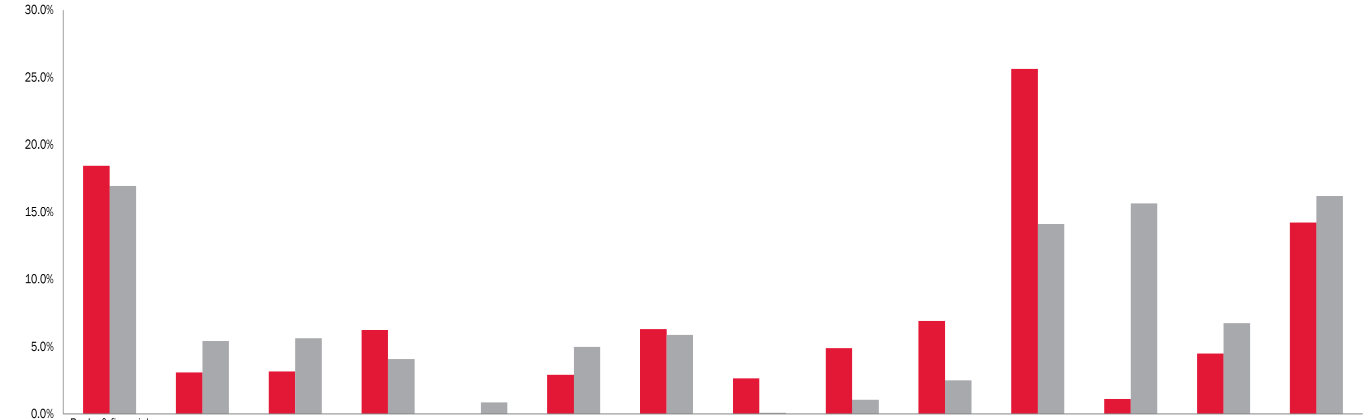
The fund objective is to outperform the benchmark by 0.8% per annum gross of the standard management fees.

The fund returns in the above table are gross of standard management fees and include the impact of cash holdings over the period.

RLPPC UK OVER 5 YEAR CORPORATE BOND FUND

Quarter 3 2013

Sector breakdown



	Banks & financial services	Consumer goods	Consumer services	Covered	Foreign sovereigns	General industrials	Insurance	Investment trusts	Real estate	Social housing	Structured	Supras & agencies	Telecoms	Utility
PPLCP	18.4%	3.1%	3.1%	6.2%	0.0%	2.9%	6.3%	2.6%	4.9%	6.9%	25.6%	1.1%	4.5%	14.2%
Benchmark	16.9%	5.4%	5.6%	4.1%	0.8%	5.0%	5.9%	0.1%	1.0%	2.5%	14.1%	15.6%	6.7%	16.2%

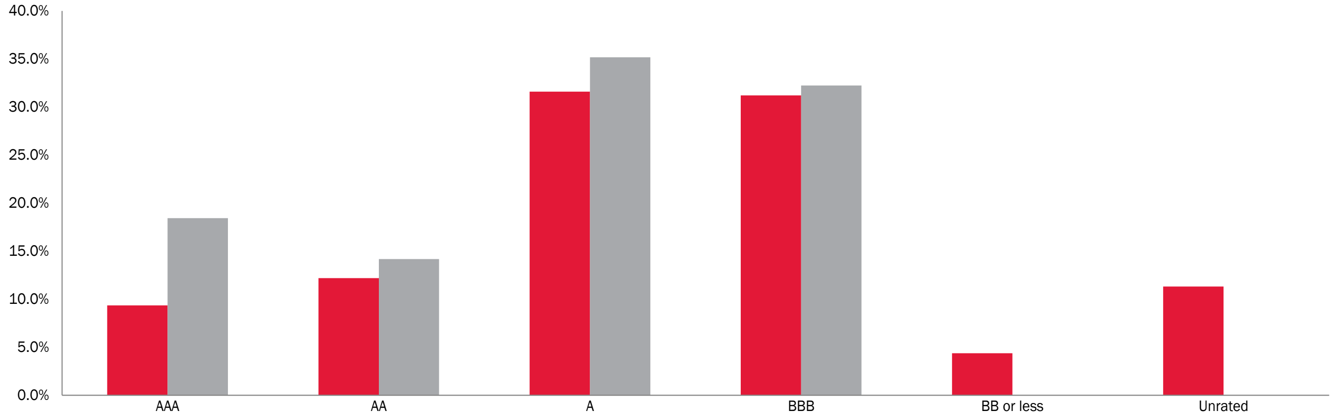
Source: rlam. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio.

What we thought	What we did	What happened	Effect on portfolio
We expected that corporate bonds would outperform sovereign and supranational debt.	A minimal exposure to supranational bonds was held in the quarter.	Sovereign and supranational bonds lagged the wider credit market.	The underweight position in sovereign and supranational bonds was beneficial.
We continued to prefer a combination of covered bank bonds and subordinated bank debt to senior bonds.	We maintained above benchmark exposures to covered and subordinated bank debt. During the latter half of the period, we reduced our overweight exposure to covered bonds.	Tier 1 bank debt outperformed strongly whilst covered bonds, having lagged the overall credit market in previous quarters this year, rebounded.	The combination of covered and subordinated bank debt was beneficial.
We thought that high profile consumer orientated bonds were unattractively priced.	We maintained an underweight exposure to such bonds.	Consumer orientated bonds outperformed UK government securities but underperformed the wider credit market.	The low weighting in high profile consumer debt was beneficial.
We continued to believe that secured bonds were undervalued relative to unsecured debt.	We maintained a significant overweight position in sectors where there is enhanced security e.g. asset backed securities (ABS), social housing and investment trusts.	Extending the trend started at the beginning of the year, secured debt remained the best performing sector outside financials. Performance was driven by continued demand for these sectors, in particular social housing.	The exposure to secured and ABS bonds was beneficial.
We thought that high yielding bonds would outperform investment grade credit bonds.	We increased exposure to higher yielding bonds through further purchases of the Royal London Sterling Extra Yield Bond Fund.	Higher yielding bonds generally outperformed; the Royal London Sterling Extra Yield Bond Fund returned 3.21% during the third quarter.	The allocation to the Royal London Sterling Extra Yield Bond Fund was beneficial.

RLPPC OVER 5 YEAR CORPORATE BOND FUND

Quarter 3 2013

Rating breakdown



	AAA	AA	A	BBB	BB or less	Unrated
PPLCP	9.4%	12.2%	31.6%	31.2%	4.4%	11.3%
Benchmark	18.4%	14.2%	35.2%	32.2%	0.0%	0.0%

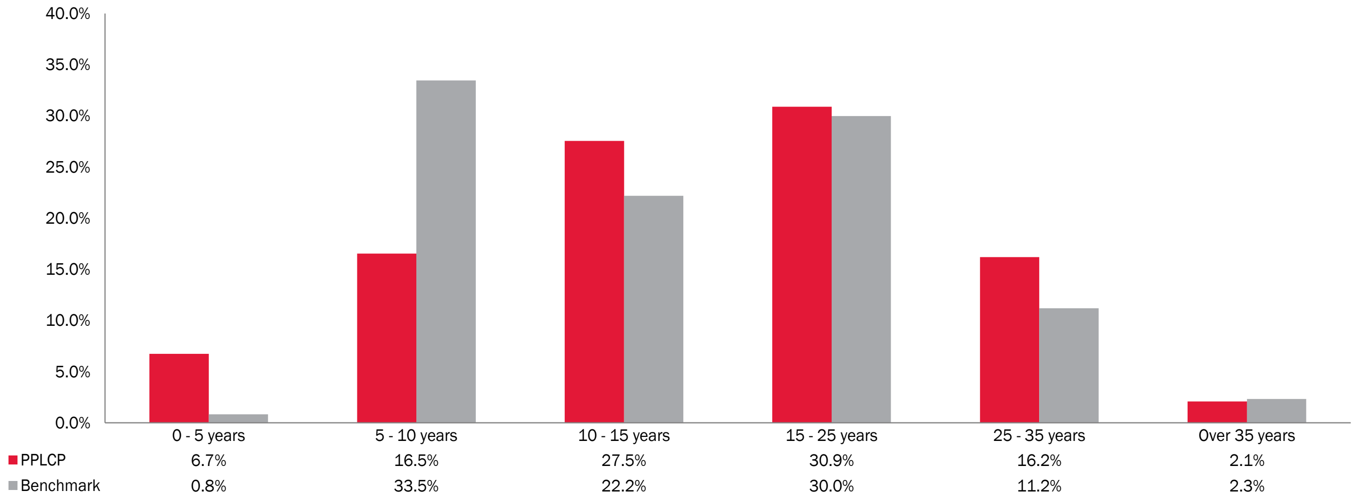
Source: rlam. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio.

What we thought	What we did	What happened	Effect on portfolio
Lower rated bonds offered better value than AAA / AA rated securities.	We maintained a bias towards lower rated bonds. Reflecting the increased exposure to the Royal London Sterling Extra Yield Bond Fund and new issue purchases, exposure to lower rated bonds was increased.	BBB and A rated bonds again outperformed, returning 2.9% and 2.7% respectively. AAA and A rated corporates underperformed, returning 0.8% and 1.6% respectively.	The credit rating profile of the portfolio was beneficial.

RLPPC UK OVER 5 YEAR CORPORATE BOND FUND

Quarter 3 2013

Maturity profile



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.

What we thought	What we did	What happened	Effect on portfolio
We thought that the rise in government yields in the first half of 2013 had taken gilt valuations closer to fair value.	The duration of the fund was maintained 0.2 years above benchmark throughout the quarter.	Credit yields fell over the period, partly mitigating the rise in gilt yields	The long duration position was a marginal positive factor in relative performance.
We believed that credit spreads were most attractive at medium and long maturities.	We maintained an overweight exposure to longer dated credit bonds.	Credit spread compression was greatest in the 7 to 10 year area of the market, narrowing by 0.35%.	Yield curve positioning was not a material factor in performance.

Ten largest bond holdings

	Rating	Weighting (%)
Abbey National Treasury 5.75% 2026	AAA	1.6
Annington Finance 0% 2022	AAA	1.5
Finance for Residence Social Housing 8.369% 2058	AA	1.4
Equity Release Funding 5.88% 2032	A	1.4
Lloyds TSB Bank 6% 2029	AAA	1.4
Circle Anglia 7.25% 2038	A	1.2
Barclays Bank 10% 2021	BBB	1.0
Nationwide Building Society 5.625% 2026	AAA	1.0
GE Capital 6.25% 2038	AA+	1.0
Annes Gate Property 5.661% 2031	bbb+ (rl)*	0.9
Total		**12.4**

Source: rlam. Figures in the table above exclude derivatives where held.
* Credit rating determined by rlam.

RLPPC UK OVER 5 YEAR CORPORATE BOND FUND

Quarter 3 2013

Fund activity

- As was expected in the summer months, new issuance activity was subdued in the early part of the quarter before showing a revival in the final weeks of September.
- New issues purchased during the quarter covered attractively priced deals across several sectors. Within real estate, we participated in a non-rated 7 year bond from **Quintain Estates**, priced at 6.5% above gilts where investors have a floating rate charge over its assets with a strong covenant package maintaining the asset cover.
- A new 'hybrid' issue of Mexican telecommunications giant **America Movil** was also purchased. Under the terms of such bonds, the issuing company has the option to defer capital repayment beyond the initial call date for the bonds, but thereby triggers interest to be reset at an increasingly penal rate. The bonds have performed well, trading a narrower yield differential over gilts than that set at issue.
- Within consumer sectors, we purchased new bonds from high street retailer **Next** and multinational tobacco company **BAT**, while within social housing, we participated in a new issue from East London-based **Poplar Housing**.
- Secondary purchases included adding to existing positions within the fund, including social housing bonds from **Circle Anglia** and **Commonwealth Bank of Australia** covered bonds. We also established new positions in covered bonds of **National Australia Bank** and investment trust **Scottish Mortgage & Trust**.
- The fund added to its position in the Royal London Sterling Extra Yield Bond Fund, a collective investment scheme biased towards rated, unrated and sub investment grade higher yielding bonds; exposure to the Royal London Sterling Extra Yield Bond Fund was raised to approximately 3.5% of fund assets.
- Sales during the quarter were biased towards low yielding securities, including covered bonds from **Coventry Building Society** and **Leeds Building Society**, pharmaceutical corporation **Pfizer** and supranational **EIB**. The strength of subordinated financial debt led to a reduction in exposure to **Lloyds Banking Group**, **BNP** and **Societe Generale**.
- Another notable sale during the quarter was a reduction of holdings in Italy's former state-owned phone company, **Telecom Italia**, following continued poor earnings and clashes with shareholders over strategy to reduce debt and maintain an investment grade rating.

Key views within the portfolio

- A significant underweight in supranational bonds as we expect credit bonds to outperform.
- Duration is marginally above benchmark; we expect any further rise in UK government bond yields to be 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.

ECONOMIC REVIEW

Key points

- Recent data on the global economy has been consistent with some improvement in the growth prospects in some Advanced Economies, though this has been offset by weakness in some Emerging Markets.
- The US Federal Reserve (Fed) postponed the expected 'tapering' of their quantitative easing bond purchases.
- The Bank of England adopted formal forward rate guidance.

Growth

- Growth prospects for some Advanced Economies improved over the quarter, most notably in the UK and eurozone. However, underlying vulnerabilities in the eurozone remain, and there was pressure on Emerging Market economies with large current account deficits. An improving trend in much of the economic news and the prospect of 'tapering' of asset purchases by the Fed were key drivers behind market developments during most of the period, and interest rates rose across the yield curve.
- In the UK, growth forecasts moved higher in response to stronger gross domestic product (GDP) and business survey data. Consumer confidence rose sharply and the recovery in the housing market gained momentum: mortgage approvals in August were 30% higher than a year earlier, while average house prices were 5% higher, having risen more in some parts of the country, particularly London. Nevertheless, activity in the housing market remained well below pre-crisis levels and debt servicing costs are low. Early estimates suggest that UK GDP increased by almost 1% in the first half of 2013. However, productivity remains weak and the responsiveness of supply capacity to a pickup in demand is a key uncertainty facing the Monetary Policy Committee (MPC).
- In the US, some sectors of the economy, such as housing, have been strong for much of the year. However, other evidence suggests that growth in the middle part of the year has been curtailed by cuts in government spending (sequestration) and tax rises. Towards the end of the quarter, there were some signs of weakness in the housing data, most likely in response to a rise in mortgage rates. During the quarter, there was much commentary on the likelihood or otherwise of the Fed reducing the pace of its asset purchase programme. However, with the labour market data not strong enough and, in reaction to rising mortgage rates, the expected change at the September Federal Open Market Committee (FOMC) meeting was not introduced.
- US non-farm payrolls have risen by close to 200,000 a month in recent quarters. However, over the recovery as a whole, employment growth has been modest, leaving the employment rate broadly flat. The number of people neither in work nor actively seeking a job has risen significantly, reflecting both cyclical and structural factors. The resulting decline in participation has contributed to much of the fall in the unemployment rate, which has fallen from its peak of 10.0% in October 2009 to 7.3% in August 2013.
- Euro-area GDP rose by 0.3% in the second quarter and business surveys suggest a further expansion in the third quarter, as the impact of reduced uncertainty around the Euro feeds through to household and business confidence. Towards the end of the third quarter, there were growing concerns about the logistics of another bailout for Greece and the political situation in Italy.
- In Asia, growth in China's GDP was 7.5% year-on-year (yoy) in the second quarter, slightly weaker than the 7.7% yoy in the first quarter. The main business surveys have suggested some pick-up in activity and electricity production. Japanese output rose by 0.6% in the second quarter, compared with average quarterly growth of 0.1% in 2012, driven by trade and consumption. Stronger domestic demand has reflected improved sentiment in anticipation of policy reform, following the change of government in December 2012 and the April announcement of a monetary stimulus package. Output growth is likely to have remained reasonably robust in the third quarter, with the main business and consumer survey indicators remaining strong.

Inflation

- UK consumer price index (CPI) inflation was 2.7% in August. The elevated rate of inflation reflects an unusually high contribution from administered and regulated prices. Looking ahead, the continuing impact of higher university tuition fees and rises in domestic utility prices should keep CPI above target for some time.

Interest rates

- With the macroeconomic backdrop still fragile, monetary policy from the main central banks remained supportive during the quarter.
- Despite stronger than expected activity data, the European Central Bank signalled its intention to keep rates low for some time. Against widespread expectations, the Fed reiterated its commitment to continue its open-ended purchases of assets at the current pace.
- In the UK, the MPC adopted formal forward rate guidance, stating that it did not intend to increase Bank Rate until the unemployment rate had fallen to at least 7%, provided this remained consistent with the Committee's primary objective of price stability and did not endanger financial stability.

Currencies

- Trade weighted sterling rose during the quarter, following a sharp fall in the early part of the year, as the improvement in UK economic data continued to boost sentiment.

BOND MARKET REVIEW

Investment grade: Financial & corporate bonds

Key points

- Sterling credit bonds returned 2.18% over the quarter; returns in all sectors were positive.
- Credit spreads narrowed over the quarter, moving from 1.56% to 1.35%.
- On a relative basis the best performing areas were banks, insurance and utilities; supranational bonds were the notable laggard.

Credit spreads

- Credit spreads narrowed materially following earlier fears stemming from widespread expectations of an imminent reduction by the US Federal Reserve of their monthly asset purchase programme.
- At the end of September, the average credit spread was 1.35% above government bond yields, 0.21% below the spread level prevailing at the end of June 2013.
- All sectors saw a narrowing of credit spreads; supranational bonds saw the smallest spread compression.

Financial sectors

- Bank debt performed strongly in the third quarter, led by subordinated bonds. This reflected clarifications by the European Banking Authority (EBA) surrounding the eligibility of innovative subordinated debt for total capital ratios under Basel III. Contrary to expectations, the EBA suggested subordinated debt not called would automatically not qualify towards a bank's regulatory capital, making these bonds uneconomical and therefore significantly increasing the likelihood of them being called. Renewed confidence in the banking sector was also reflected by the sale of part of the UK government's stake in Lloyds Banking Group.
- Having lagged through most of the year so far, covered bonds rebounded as appetite for the product returned.
- The insurance sector was relatively strong, recording a return of 3.96%.

Non-financial sectors

- All credit sectors outperformed UK government bonds. Utilities and asset backed securities performed particularly well, while supranational bonds recorded the lowest spread compression during the quarter. Consumer sectors continued to underperform.
- Peripheral corporate bond performance was mixed. While Spanish corporates performed well, supported by a fall in sovereign yields, Italian corporates underperformed. This reflected issues surrounding the country's growth prospects, political instability as well as stock specific concerns (for example, Telecom Italia). Away from peripheral Europe, corporate Emerging Market debt failed to recover from earlier US taper-induced weakness.
- Market technicals remained supportive with issuance during the quarter the lowest this year at £7.9bn, and lower, year to date, than in 2012. As has been the trend over 2013 so far, issuance was dominated by non-financials.

Ratings and maturities

- Lower rated bonds again outperformed, reflecting the on-going search for yield. BBB rated bonds gave a return of 2.90% whilst A rated securities gave a return of 2.67%. Credit spreads contracted by 0.40% for BBB and 0.24% for A rated bonds.
- Highly rated securities underperformed the wider market with AAA and AA bonds recording returns of 0.83% and 1.58% respectively, representing credit spread compression of 0.05% and 0.12% respectively.
- Longer dated credit bonds gave the best returns, reflecting their greater interest rate sensitivity. Over 15 year bonds gave a return of 3.03% with credit spreads recording a contraction of 0.20%. By credit spread movement, medium dated bonds were the best area with the yield premium over UK government securities of 7 to 10 year bonds falling by 0.35%.

Outlook

- Credit spreads ended the quarter at the lower end of their 2013 range; nevertheless, we continue to believe that the pricing of credit bonds undervalues the asset class, relative to government securities.
- The rise in government bond yields during 2013 has reduced the over-valuation of government bonds and we do not expect a significant increase in yields in the forthcoming quarter.
- We expect that investment grade credit bonds will outperform UK government securities by at least 1.5% p.a. over the next three years.

BOND MARKET REVIEW

Index linked bonds

Key points

- Index linked gilts returned 0.59% over the quarter.
- UK consumer price index (CPI) inflation fell to 2.7% in August.
- The market digested two long dated index linked syndications during the quarter, including a £5bn 2068 maturity. The Debt Management Office (DMO) announced that there will be two long dated index linked gilt syndications, including the possibility of a super-long gilt issue, which should weigh on long dated index linked gilts, weakening their performance versus conventional gilts.
- Markets were volatile over the quarter, with yields driven by economic data and the debate regarding the likelihood of the US Federal Reserve 'tapering' their monthly asset purchase programme but, by the end of the quarter, yields were little changed.
- The 2013 index linked gilt redeemed, leading to demand for shorter dated bonds, which outperformed over the quarter.
- Oil prices were higher over the quarter, as the Syrian crisis intensified, but fell towards the end of the quarter as negotiations towards a diplomatic solution began.
- Breakeven inflation rates ended the quarter around 0.1% higher at the 10 year maturity point but unchanged at the long end.

Real yield and breakeven (implied) inflation curve moves

- Real yields fell at the beginning of the quarter, particularly at shorter maturities, as the market awaited news on the UK adopting forward guidance. However, with two long dated syndications in July and September, real yields rose from the middle of July, ending the quarter close to their highest levels since the Consumer Prices Advisory Committee (CPAC) decision regarding retail price index (RPI) index calculation methodology in January.
- Over the quarter, shorter dated breakeven rates rose by 0.1% as the rising oil price increased demand for shorter dated inflation assets. Longer dated breakeven rates were barely changed, reflecting the heavy supply at the longer end of the market.

Variation of return across the UK market

- The yield differential between 10 and 30 year bonds ended the quarter barely changed at 0.5%. However, this disguised a volatile quarter over which the differential traded between 0.4% and 0.8%. Longer dated bonds underperformed, particularly prior to the £4bn 2044 index linked gilt syndication in July.
- The FTSE Index Linked All Stock Index gave a return of 0.59% over the quarter, leaving the twelve month return at 5.77%. Short dated and 30 year bonds posted the best returns over the quarter, in the region of 1.5%, whilst 10 and 20 year bonds underperformed.

Overseas and credit index linked market

- Overseas bonds were volatile when compared to the UK, with the long end of the US market suffering from heavy institutional selling and an expectation of 'tapering' in September. The long end real yield differential rose to a year high of 1.5% before falling back to 1.25% on the no 'tapering' decision. Other overseas markets were less volatile and generally finished the quarter close to June levels.
- 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 zero whilst analysts' forecasts for real GDP are generally rising.
- Demand remains for longer dated real yields from pension funds. With supply concentrated at the longer end of the market, we would anticipate a marginal steepening of the yield curve in the final 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 1.0% and 1.5% higher than the UK.
- Our real yield forecasts for 10 and 30 year index linked gilts at the end of 2013 are -0.1% and 0.5% 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 0.47% over the quarter.
- The Bank of England Monetary Policy Committee (MPC) left policy and quantitative easing unchanged at 0.5% and £375bn respectively, with no members calling for further stimulus. The introduction of forward guidance suggested that interest rates would remain at the current level at least until unemployment fell to 7%; the MPC currently expects this to occur in late 2016, also clarifying that this level is a trigger at which to re-assess the economy. The caveat to this was increased inflation at the horizon point and/or destabilisation of the economic outlook.
- UK consumer price index (CPI) inflation fell to 2.7% in August, while second quarter gross domestic product (GDP) rose to 0.7%, resulting in 1.3% year-on-year (yoy) growth.
- Issuance was spread between 5, 10 and 30 year maturities; the Debt Management Office (DMO) announced that there will be a further 2068 conventional syndication in October. The market also digested two long dated index linked syndications during the quarter.
- Medium dated gilts underperformed long and short dated gilts on a risk adjusted basis as data continued to improve and the market expected the US Federal Reserve (Fed) to 'taper' its asset purchase program in September. However, the Fed did not taper, leading to a US bond rally led by 5 year maturities in the final few weeks of the quarter.
- European data improved, with the eurozone moving out of recession, helping to tighten peripheral bond spreads; some marginal widening of spreads occurred towards quarter end on German election, Italian political and US budget/debt ceiling concerns.

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 spread between 5, 10 and 30 years over the quarter in conventional gilts. Index linked issuance was more skewed towards 10 and 30 year maturities.
- Conventional gilt issuance for the upcoming quarter will be concentrated in the 5 to 10 year area of the curve, albeit with a 2068 conventional gilt syndication in October.
- Conventional gilt yields rose 0.10% at short maturities, 0.07% at medium maturities and fell -0.05% at long maturities.

Variation of return across the UK market

- Overall, the UK government bond market gave a total return of 0.47% during the quarter, with short dated gilts returning 0.04%, medium dated gilts -0.12%, and long dated gilts 1.33%.

Overseas fixed interest markets

- Short and medium dated gilts performed broadly in line with US and European government bonds, reflecting the better domestic global data. Long dated gilts outperformed their overseas counterparts as higher real and nominal yields were met with strong liability driven investment (LDI) demand from the UK pension fund community.
- Yields in core overseas markets rose over the quarter, while peripheral European countries outperformed. Spanish and Italian governments continued to issue their debt relatively smoothly over the quarter.
- The Fed surprised bond markets in September by not 'tapering' their asset purchase programme, citing downward risks to growth expectations and the need for more data before proceeding. This resulted in a strong US bond rally led by 5 year maturities.

Outlook

- Our central case is for gilt yields to rise marginally over the next twelve months. We remain cautious on the outlook for global growth as the deleveraging process will take several years. Recent improvement in UK growth is encouraging, but the economy still remains some way below the long term trend.
- We expect gilt market volatility to continue, given the continued high levels of global supply, political concerns and concerns over the impact of fiscal and monetary 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 5, 10 and 30 year conventional gilt yields are 1.7%, 2.8% and 3.8% respectively; current yields are 1.5%, 2.7% and 3.5% respectively.

BOND MARKET REVIEW

Overseas government bonds

Key points

- The US Federal Reserve (Fed) surprised markets with its decision not to taper the pace of asset purchases.
- US employment reports remained moderate, but the participation rate weakened.
- US politicians were in deadlock over agreeing a new budget; failure to reach an agreement before 30 September led to a shutdown of non-essential government services.
- Former US Treasury Secretary Larry Summers withdrew as a candidate to succeed Ben Bernanke as head of the Federal Reserve.
- European survey data picked up; the eurozone exited recession, led by French and German growth.
- The fragility of the Italian government was highlighted as former Prime Minister Silvio Berlusconi's PDL party threatened to pull candidates from the coalition and to remove support for the government, triggering a future vote of confidence in current Prime Minister, Enrico Letta.
- The Bank of England's Monetary Policy Committee provided forward guidance for the path of rates, with unemployment being the target measure.

Yield curve moves over the quarter

- Yield moves were mixed over the period.
- The surprise decision by the Fed not to reduce the pace of their monthly bond purchase programme led to a rally in most medium dated government bond markets of approximately 0.3%.
- Prior to this, yields had risen as markets brought forward expectations of rate increases, in defiance of central bank indications.
- At the end of the quarter, medium dated government bonds in the US and Canada posted small yield rises and declines in German and Japanese markets; 10 year government bond yields in the US, core Europe, Japan and the UK were 2.7%, 1.8%, 0.7% and 2.7% respectively.
- Implied inflation rates rose over the quarter, in part due the Fed's decision not to taper (which would have brought about a fall in inflation expectations over the medium term).
- At the end of the quarter, 10 year real yields in the US, core Europe and the UK were 0.5%, 0.2% and -0.5%. Accompanying breakeven rates were 2.2%, 1.6% and 3.2%.
- Yield curves steepened marginally over the period with the exception of the UK, which flattened.

Currency markets

- Over the quarter, sterling strengthened against the basket of currencies in the indices.
- The largest moves were against the US Dollar and 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 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.

BOND MARKET REVIEW

Global high yield bonds

Key points

- The global high yield market returned 2.5% over the quarter, with quite varied monthly returns over this period (July 1.8%, August -0.5% and September 1.1%). Year to date returns for the asset class are 3.5%.
- The best performing sectors were real estate (4.8%) and insurance (4.1%). Consumer non-cyclicals (1.3%) and utilities (0.7%) were relative laggards.
- Global new issuance in the quarter was over $104bn, down 12% on the same period last year due to a particularly low level of issuance in August. At the end of September, issuance year to date stood at over $360bn, 85% of the total for the record year of 2012. The US and Europe account for 58% and 21% of this year's new issuance, respectively, with emerging markets and other developed markets issuing the remainder.
- The yield on the global high yield market index ended the quarter down 0.4% at 6.3%. The average high yield credit spread was 5.2% above government bond yields, having tightened 0.4% from 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 region returned 2.1% for the quarter, after being up 2.8% for the first three weeks of the period. August was a difficult month for the region, with higher government yields and the expectation of a 'tapering' of supportive monetary policy. A rebound occurred in September as monetary policy remained unchanged and government yields fell back to levels witnessed at the start of August.
- In a repeat of the second quarter, Europe outperformed other regions, returning 3.7% due to the greatest amount of spread tightening, helped by the most attractive relative valuations to start the period.
- The Emerging Markets was the weakest performing region, returning 1.9%. This region produced effectively flat returns over the first two months of the quarter, with a strong recovery in September. This strong close to the period was due to lower US government yields, which had risen persistently since early May and due to better than expected Chinese economic data.

Monthly performance

- July benefited from both a stabilisation of US treasury yields and a return of investor flows after the turbulent months of May and June, during which there was much talk of 'tapering'. The subsequent recovery of the market was due to US Federal Reserve commentary on monetary stimulus, stating that its removal was "by no means on a pre-set course".
- In August, Global High Yield suffered from rising government yields on better than expected economic data. This unsettled investors, already concerned over 'tapering' and a lack of clarity with regards to the next Chairman of the Federal Reserve. The potential of a US military strike on Syria partially reversed the move in government yields at the end of the month.
- In September, the market benefitted from several supportive factors; reduced risk of military action in Syria, better than expected economic data from China, and the withdrawal by Larry Summers from consideration for Chairman of the Federal Reserve. Most notable, however, was the US monetary policy decision not to taper monetary stimulus but to leave the monthly pace of asset purchases unchanged. The strong performance during the month was cut back by commentary that the decision to taper purchases may in fact be only delayed to October. Political concerns in the US over the impending government shutdown and debt ceiling also weighed on investor sentiment.

Ratings & maturities

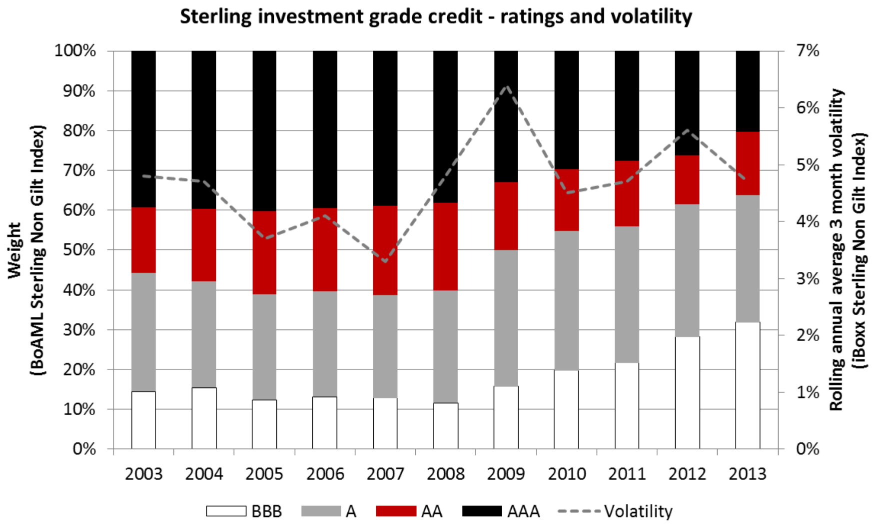
- For the quarter, lower rated bonds generally outperformed. BB, B and CCC and lower rated bonds returned 2.3%, 2.5% and 3.2% respectively for the quarter. Yields at the end of the quarter stood at 5.3%, 6.5% and 10.4%, respectively.
- Returns for the quarter were broadly worse for longer maturity assets as the US government curve steepened over the period. Global high yield returns were 2.8% for 0-3 years, 3.1% for 3-5 years, 3.0% for 5-7 years, 1.7% for 7-10 years and -0.3% 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 the remainder of 2013.

Credit market liquidity: improving or deteriorating? Why this is the wrong question.

Credit markets have been relatively volatile over the last six years. Prior to the financial crisis of 2008-9, the average credit spread on investment grade sterling credit bonds was around 0.5%. In the depths of the crisis, this spread reached 4.5% and has fallen fairly steadily since then to 1.4% at present. This still significantly over-compensates investors for the risk of holding credit bonds, rather than government bonds, and it is our expectation that credit spreads will continue to decline, although they are unlikely to challenge the levels seen prior to the crisis. This reflects a combination of structural changes (e.g. higher weighting of lower rated investment grade bonds in the market) and some psychological factors (e.g. fear of a repeat of 2008-9).



Source: Bloomberg, Markit iBoxx, Bank of America Merrill Lynch; Data as at 30 September 2013.

One factor that is often cited for the relative undervaluation of credit bonds is liquidity, i.e. the higher transaction costs and the lower dealing sizes in credit relative to government bonds. At this point, a bit of historical perspective is helpful. In Europe and the UK credit markets have grown very strongly over two decades, reflecting many factors e.g. low absolute interest rates, the desire for long term finance, maturing of pension funds (and the demand to obtain long term cashflows offered by credit bonds) and, more recently, the deleveraging of bank balance sheets (capital markets have partially replaced bank funding). In the “sunny uplands” of the earlier 2000s it was envisaged by some that credit markets would mirror the characteristics of equity markets: high liquidity, greater price transparency, active derivative markets etc.

For a variety of reasons, the evolution of credit markets has been patchy. Credit derivatives have developed but liquidity and transparency have not followed suit. In part, this reflects the differences between credit bonds and equities. On the face of it there is not much difference; equity is lowest in the capital structure of a company and unsecured debt (the predominant form of credit bond finance) ranks just above. However, there are many structural differences. End investors in credit markets typically want predictable long term cash flows, they tend to be risk averse and focus on what can go wrong. Equity investors are more interested in long term growth opportunities and what can go right. This is reflected in the nature of credit bond and equity portfolios; the former tend to be much more diversified. Trading venues (programme trading, dark pools etc.) are also more developed in equity markets, with credit investors more dependent upon primary issuance to create liquidity.

One interesting feature of recent months has been a perceived decline in liquidity in credit markets. This partly reflects the withdrawal of capital by banks from their credit trading businesses but also the “feast or famine” nature of markets i.e. small changes in investor sentiment can have disproportionately large impacts on relative valuations. This can make trading bonds very difficult. There is also increasing evidence that credit markets are bifurcating, with liquidity being concentrated in the largest issues and the rest experiencing lower price transparency and liquidity. The investment and disinvestment of large and frequent cashflows by many large asset managers, particularly for vehicles such as momentum-based trading funds, results in many managers chasing the same liquid bonds, forcing credit spreads tighter (e.g. EDF, RWE, AT&T, Wal-Mart, KFW, EIB and GE), or holding a growing percentage in UK government bonds.

Whilst this may sound a recipe for buying only liquid bonds the reverse is the case (if you can get hold of them); large swathes of credit bonds are being overlooked and, consequently, unloved, resulting in a significant valuation gap opening up between the large liquid issues and those bonds which trade less frequently and where patience is required to source. For long term investors it makes sense to focus on some of the unloved areas. First, valuations are more attractive. Second, they can offer greater economic / sector diversity. Third, they often have features that are particularly attractive e.g. enhanced security and better covenants. RLAM believe that by using our knowledge on these overlooked areas of credit markets we can offer our clients a better risk / return trade off, with attractive cashflows across a diversified range of bonds. While this may not appeal to investors looking for a strategy based on quick moves in and out of credit, we feel that such a strategy is strongly challenged in present market conditions.

INVESTMENT OUTLOOK

Key points

- Our central case assumes 2.1% gross domestic product (GDP) growth in the UK in 2014, a return to growth in the Euro-area, and continued modest growth in the US.
- UK interest rates are set to remain on hold at 0.5% until late 2015 at the earliest and remain low relative to inflation, which will remain above target over the next 12 months.
- We remain positive on credit bonds relative to conventional and index linked government bonds.

Global economic growth prospects

- Economic news in the US and Japan has come in broadly in line with our base case expectations; we have raised growth forecasts for the eurozone, China and UK in response to stronger than expected survey and official data. Our central assumption, however, remains that the acute nature of the financial crisis, and in particular the large rise in debt levels which preceded it, means that recovery will be lengthy and subject to volatility. Our base case continues to assume a modest reacceleration of global activity during 2014, thanks to some pick up in the US and eurozone economies. However, we do not expect a quick return to pre-crisis conditions.
- The UK has experienced the weakest recovery from recession since World War 2, despite prolonged loose monetary policy. Looking ahead, we assume consumer spending growth is positive but constrained by the slow improvement in real incomes, and net trade benefits from better conditions in the UK's main export markets, while investment receives a boost from housing and business investment. This equates to a modest pick-up in growth over 2013 to 1.4% and 2.1% growth in 2014, slightly below its long term trend. It is difficult to be more bullish than this, unless we expect a much larger improvement in net trade and/or a much more buoyant consumer.
- Our base case indicates a small pick-up in US growth in 2014, assuming the pace of fiscal consolidation slows. Private sector demand should be underpinned by rising household wealth, owing to the housing recovery, and still supportive financial conditions. However, the pace of growth is expected to be modest rather than robust. In Japan, growth is expected to slow in 2014, as the effect of the initial stimulus wears off and consumption taxes are increased. Eurozone growth is forecast to increase to 1% in 2014. In China growth is to average 7.5% in 2013-14, with the 2013 forecast increased from 7% on account of stronger official and survey data since June.
- The impact of the eurozone crisis on 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, 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 Inflation (CPI) is likely to remain above target over the next 12 to 18 months, reflecting a persistent contribution from administered and regulated prices, such as university tuition fees and 'green' energy taxes; demand and supply balance drive 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.
- The Monetary Policy Committee expressed its intention not to raise the Bank Rate or to reduce its stock of asset purchases at least until unemployment has fallen to 7%, subject to three 'knockout' conditions. We 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

- While government bond yields have risen, investors are still paying a high price for the prospect of very low real returns. We do expect yields to move higher from current levels. 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 modest 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% over the coming 12 months.

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 CIO.
- 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 fund managers

Jonathan Platt
Head of Fixed Interest

Paola Binns
Credit Fund Manager

Our philosophy

We aim to achieve long-term outperformance by active management and taking advantage of market inefficiencies. We believe in value investing and generally take investment positions for the 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.

Client Account Management & Distribution teams' changes

We welcome two Client Account Administrators to the Client Account Management team, Mark Elbourne and George Barbett. Mark and George have recently completed their studies and will be helping us with reporting, client administration, audits and query resolution, as well as providing support to our Client Account Managers and Directors.

Georgina Montalvo, Client Account Manager, has rejoined the Client Account Management team following her maternity leave. Sophie Niwaz, who was helping out in the interim, left the team in September.

Kate Parker has joined the Distribution team as an Institutional Business Development Manager. Kate's main focus will be on the Local Authority sector. Kate joins us from Payden and Rygel where she was their Institutional Business Development Manager since 2009. Kate has 16 years' experience of the institutional market.

Portfolio Risk team changes

Timothy van den Hoek-Eklund has joined the corporate bond team as a trainee credit analyst. He began his career in 2010 at Occam Asset Management where he worked as an equity research analyst focused on global emerging markets. Following the acquisition of Occam by Liontrust Asset Management in 2011, Timothy continued to work as part of the emerging markets team and was responsible for financial modelling and analysis of companies across a diverse range of sectors. Timothy holds a first class degree in Economics from the University of Liverpool and is currently studying for the CFA Level III.

Timothy Shaw has joined the Portfolio Risk team as a Portfolio Risk Manager. Tim joins us from F&C Asset Management where he was most recently an Investment Risk Analyst. Prior to this Tim was an Investment Risk Research Analyst at IDD, a Forecasting Modeller at Capita and a Risk Analyst at the Ministry of Defence. Tim holds a degree from UCL and a MSc in Quantitative Finance from Westminster Business School.

RLAM

Your dedicated contact

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In James's absence, please feel free to contact any of the Client Account Management team members listed below or email: rlamclientaccountmanagement@rlam.co.uk

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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 which 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, FCA 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.

Underlying yield - 'Underlying yield' is a datum required by the IMA, Investment Management Association, for authorised funds. Its purpose is to provide additional information, as distribution yield in isolation can be insufficient and potentially misleading. Underlying yield is calculated taking into account the expenses of the fund and it aligns closely with the gross redemption yield of the fund, which is also provided above.

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.

Source: rlam.

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739-PRO-10/2013-AS

Portfolio Valuation

As at 30 September 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								
110,404,809	RLPPC Over 5 Year Corp Bond Pen Fd	1.70901	120,712,016.03	188,682,922.00	0.00	188,682,922.00	0	100.0
		Funds Held total	**120,712,016.03**	**188,682,922.00**	**0.00**	**188,682,922.00**		**100.0**
		Grand total	**120,712,016.03**	**188,682,922.00**	**0.00**	**188,682,922.00**		**100.0**

Trading Statement

For period 01 July 2013 to 30 September 2013

Dorset County Pension Fund

	Trade Date	Transaction Type	Nominal	Security	Price (£)	Book Cost (£)
Acquisitions						
Funds Held						
	05 Jul 2013	Acquisition Rebate	85,341.69	RLPPC Over 5 Year Corp Bond Pen Fd	1.68	143,222.99
					Funds Held total	**143,222.99**
					Acquisitions total	**143,222.99**