Insight INVESTMENT

DORSET LIABILITY MATCHING PORTFOLIO

For the period
01 October 2013 to 31 December 2013

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Investment Summary

DORSET LIABILITY MATCHING PORTFOLIO

For the period 01 October 2013 to 31 December 2013

Summary of Performance

Performance summary to 31 December 2013

	3 months (%)	1 year (%)	Since Inception (%)
Portfolio	0.52	17.61	25.36
Benchmark	-0.42	15.05	22.84
Relative Return	0.94	2.56	2.52

	3 months (£)	1 Year (£)	Since Inception (£)
Portfolio	999,857	29,242,631	45,292,700
Benchmark	-813,952	24,965,745	40,746,525
Relative Return	1,813,808	4,276,886	4,546,174

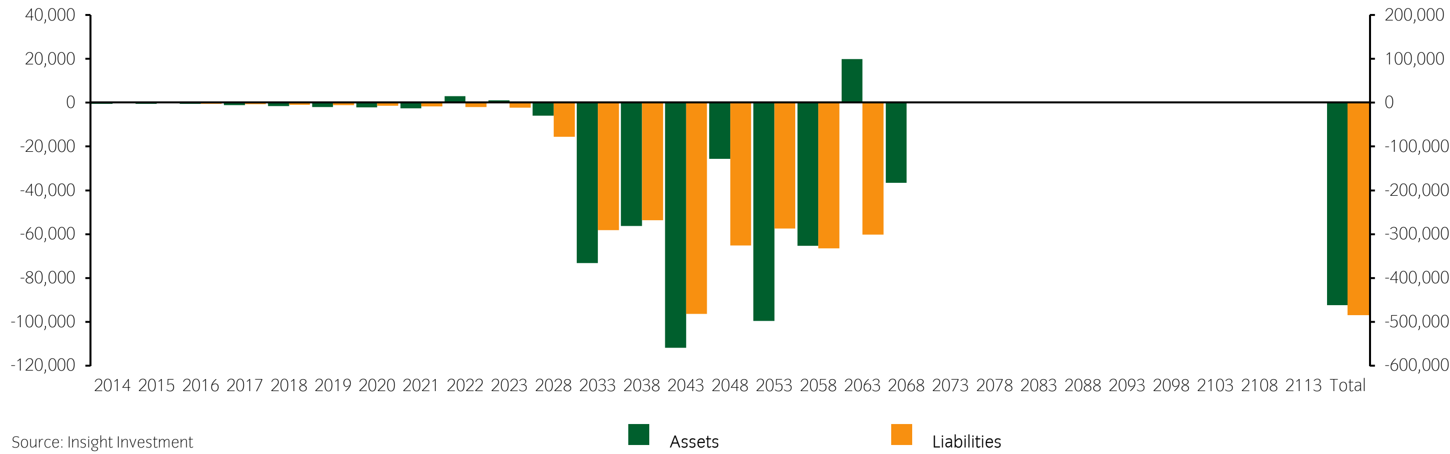
Source: Insight Investment

Inception date for performance purposes: 31 October 2012

Any footnotes relate to the current quarter-end; historic footnotes available on request

LDI Analysis

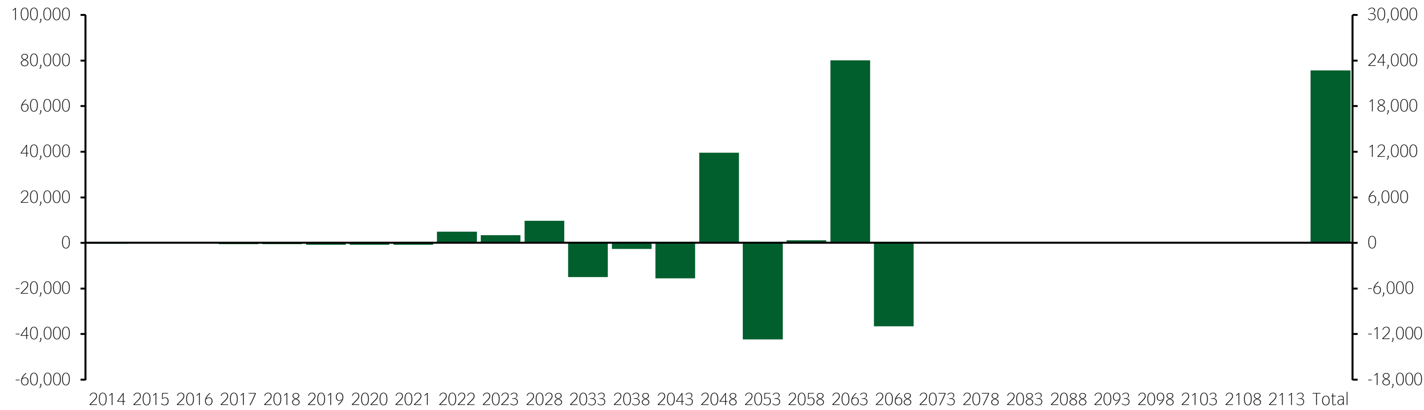
Interest Rate Risk (PV01)
Assets vs Liabilities (£)



Source: Insight Investment

Interest Rate Sensitivity (PV01): The change in the present value of the scheme assets or liabilities resulting from a 0.01% (one basis point) parallel upward shift in the discount curve.

Current Portfolio vs Liabilities (£)



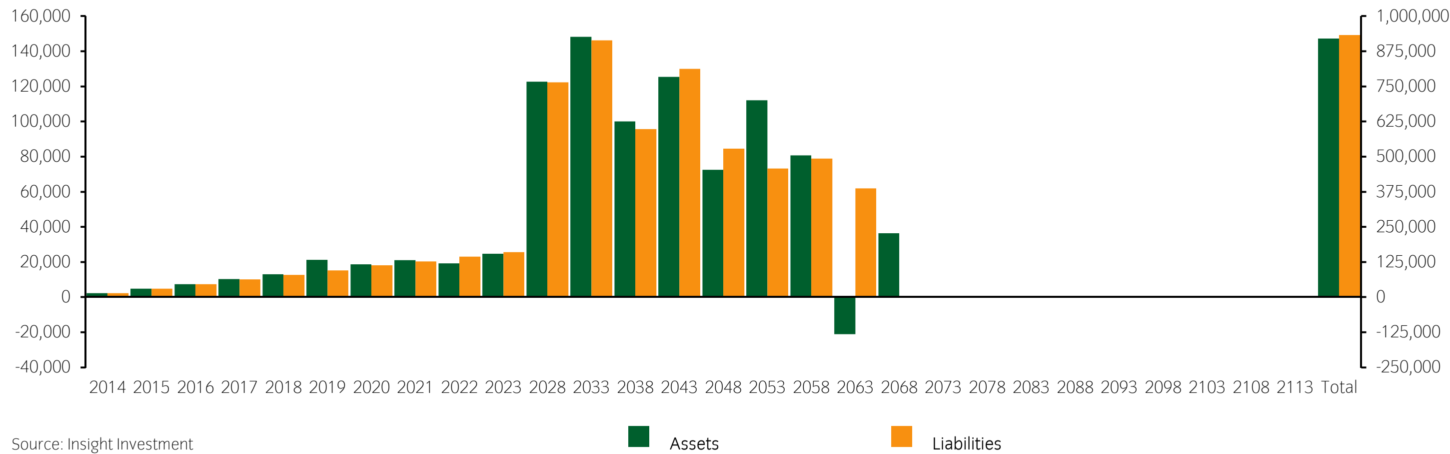
Source: Insight Investment

Note: Liability benchmark sensitivities will equal asset sensitivities where no liability benchmark is available

LDI Analysis Continued

Inflation Risk (IE01)

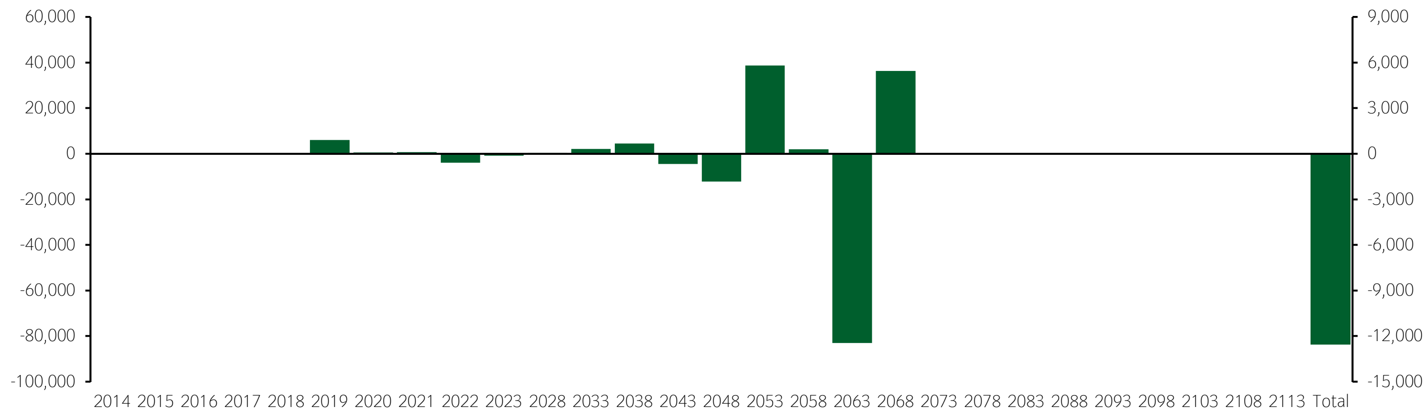
Assets vs Liabilities (£)



Source: Insight Investment

Inflation Sensitivity (IE01): The change in present value of the inflation-linked schemes assets or liabilities resulting from a 0.01% (one basis point) parallel upward shift in the inflation expectation curve.

Current Portfolio vs Liabilities (£)

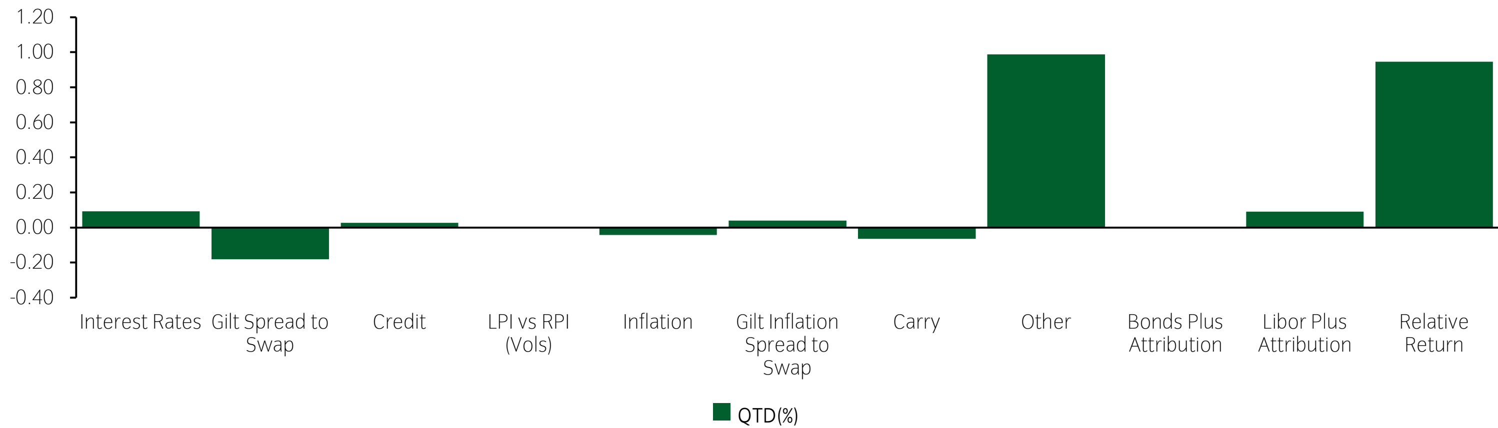


Source: Insight Investment

Note: Liability benchmark sensitivities will equal asset sensitivities where no liability benchmark is available

LDI Attribution

Quarter-to-date relative percentage attribution



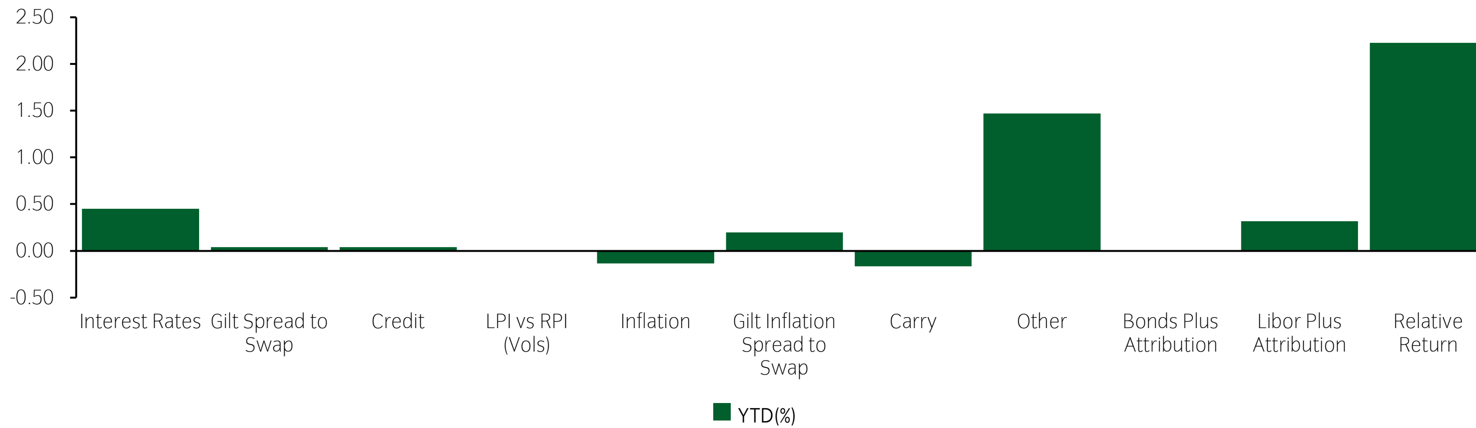
Description	QTD (%)
Interest Rates	0.09
Gilt Spread to Swap	-0.18
Credit	0.03
LPI vs RPI (Vols)	0.00
Inflation	-0.04
Gilt Inflation Spread to Swap	0.04
Carry	-0.07
Other	0.99
Bonds Plus Attribution	0.00
Libor Plus Attribution	0.09
Relative Return	0.95

Note: The percentage attributes and returns are calculated geometrically, and therefore the relative return may differ to the arithmetic percentage return shown on the returns summary page.

All figures are calculated geometrically

LDI Attribution

Year-to-date relative percentage attribution



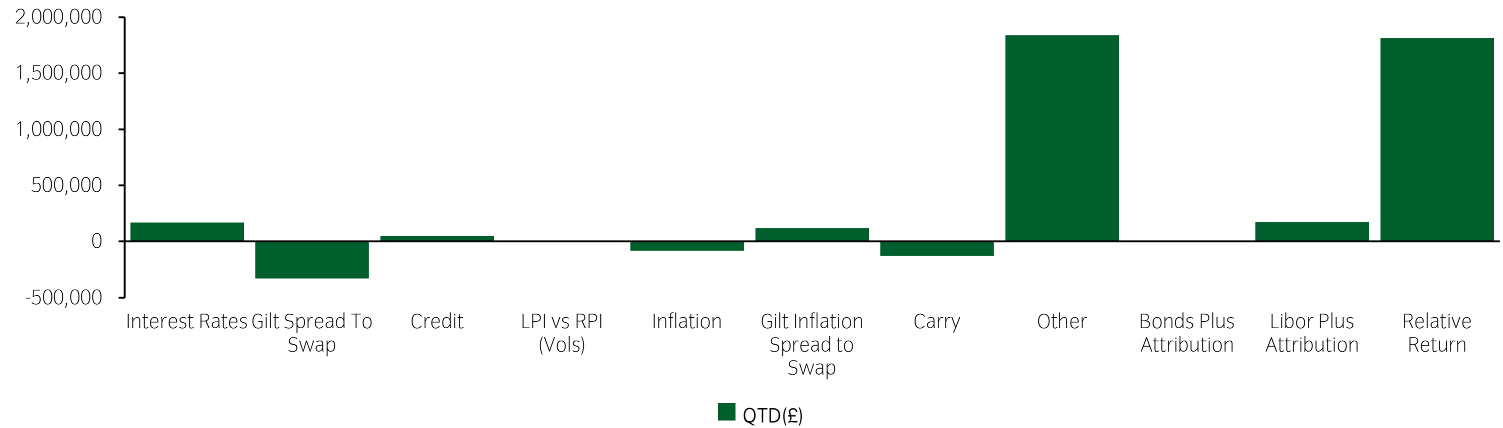
Description	YTD (%)
Interest Rates	0.45
Gilt Spread to Swap	0.04
Credit	0.04
LPI vs RPI (Vols)	0.00
Inflation	-0.14
Gilt Inflation Spread to Swap	0.20
Carry	-0.17
Other	1.47
Bonds Plus Attribution	0.00
Libor Plus Attribution	0.32
Relative Return	2.22

All figures are calculated geometrically

Note: The percentage attributes and returns are calculated geometrically, and therefore the relative return may differ to the arithmetic percentage return shown on the returns summary page.

LDI Attribution

Quarter-to-date relative monetary attribution

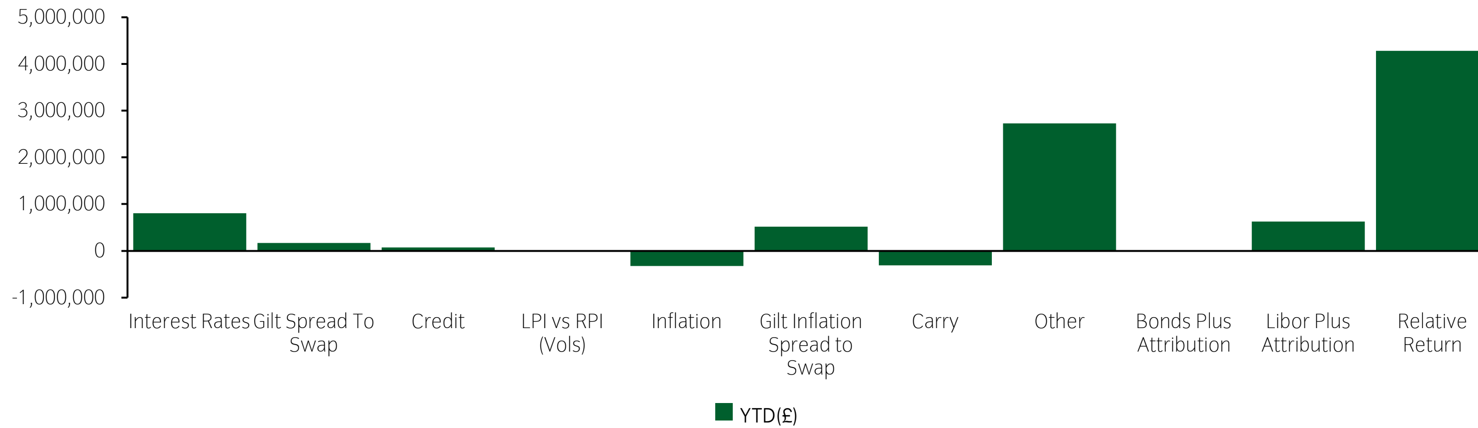


Description	QTD (£)
Interest Rates	169,009.68
Gilt Spread To Swap	-328,733.05
Credit	50,655.20
LPI vs RPI (Vols)	0.00
Inflation	-82,108.05
Gilt Inflation Spread to Swap	116,839.88
Carry	-126,713.08
Other	1,839,196.04
Bonds Plus Attribution	0.00
Libor Plus Attribution	175,661.87
Relative Return	1,813,808.48

All figures are calculated geometrically

LDI Attribution

Year-to-date relative monetary attribution

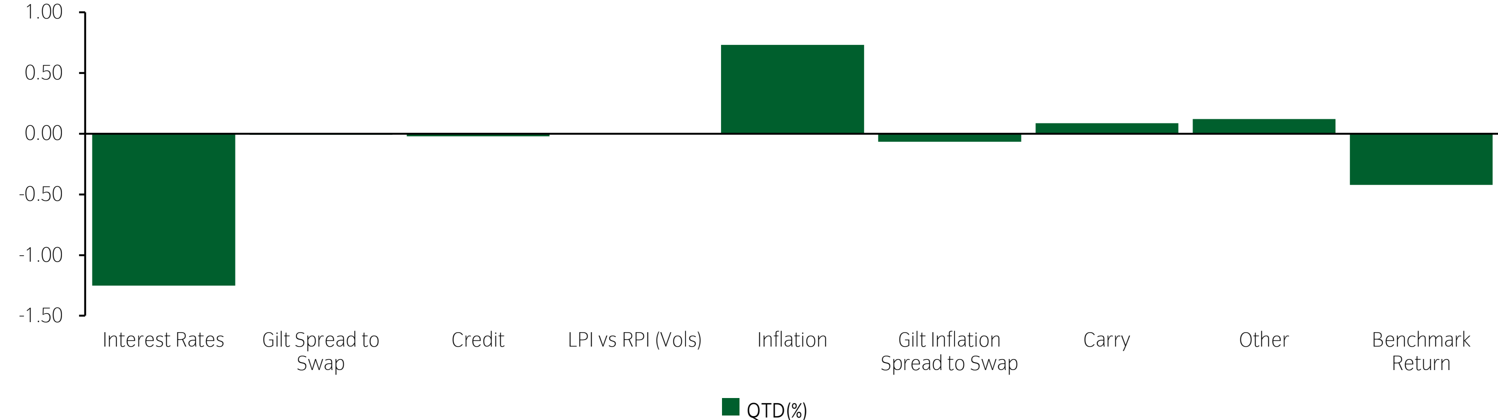


Description	YTD (£)
Interest Rates	805,277.92
Gilt Spread To Swap	166,379.66
Credit	72,561.10
LPI vs RPI (Vols)	0.00
Inflation	-324,781.58
Gilt Inflation Spread to Swap	518,029.42
Carry	-310,101.94
Other	2,725,144.42
Bonds Plus Attribution	0.00
Libor Plus Attribution	624,377.00
Relative Return	4,276,886.00

All figures are calculated geometrically

LDI Attribution

Quarter-to-date benchmark percentage attribution



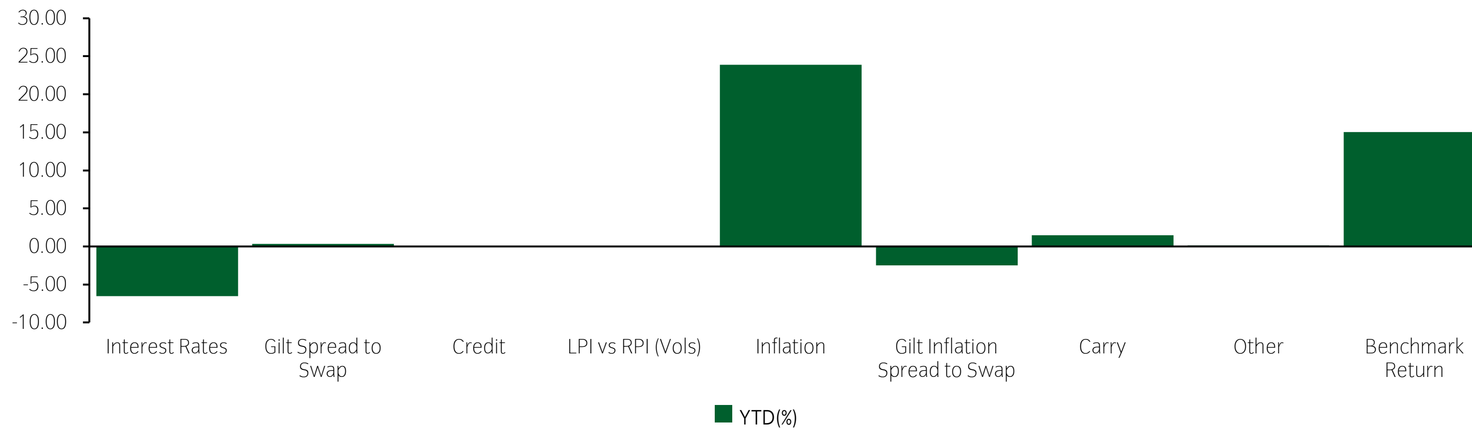
Description	QTD (%)
Interest Rates	-1.25
Gilt Spread to Swap	-0.01
Credit	-0.02
LPI vs RPI (Vols)	0.00
Inflation	0.73
Gilt Inflation Spread to Swap	-0.07
Carry	0.09
Other	0.12
Benchmark Return	-0.42

All figures are calculated geometrically

Note: The percentage attributes and returns are calculated geometrically.

LDI Attribution

Year-to-date benchmark percentage attribution



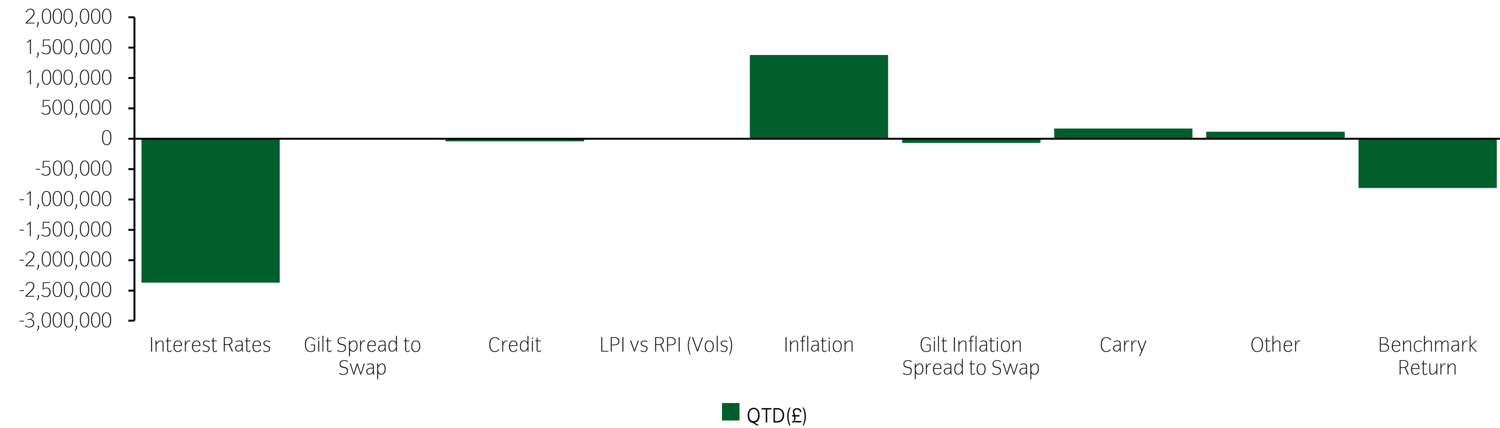
Description	YTD (%)
Interest Rates	-6.53
Gilt Spread to Swap	0.33
Credit	-0.08
LPI vs RPI (Vols)	0.00
Inflation	23.89
Gilt Inflation Spread to Swap	-2.48
Carry	1.48
Other	0.15
Benchmark Return	15.05

Note: The percentage attributes and returns are calculated geometrically.

All figures are calculated geometrically

LDI Attribution

Quarter-to-date benchmark monetary attribution

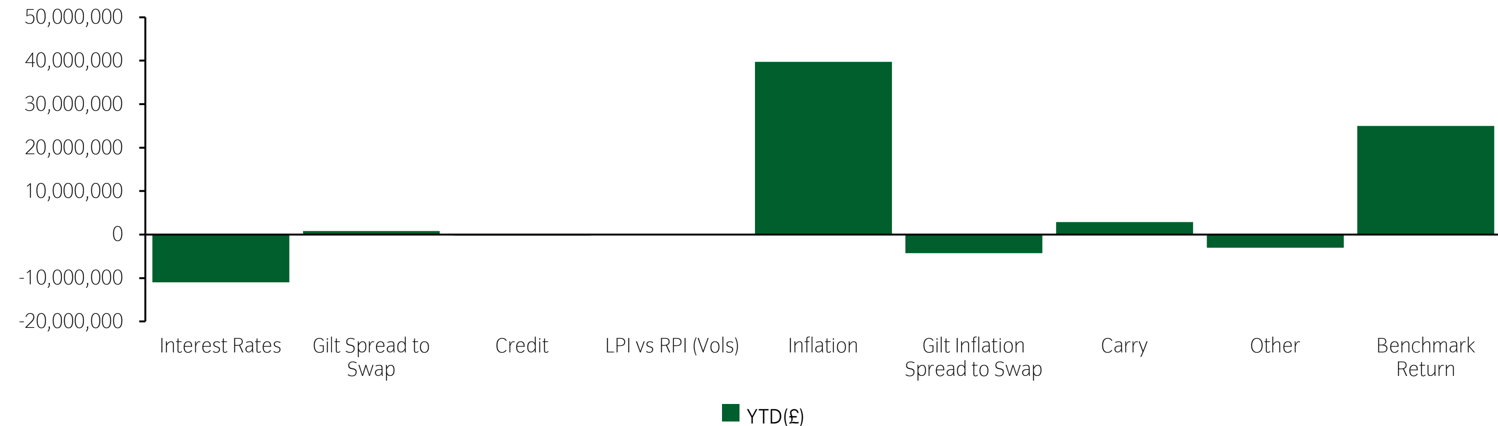


Description	QTD (£)
Interest Rates	-2,369,588.37
Gilt Spread to Swap	13,140.22
Credit	-43,012.82
LPI vs RPI (Vols)	0.00
Inflation	1,377,523.31
Gilt Inflation Spread to Swap	-71,725.70
Carry	166,871.90
Other	112,839.91
Benchmark Return	-813,951.55

All figures are calculated geometrically

LDI Attribution

Year-to-date benchmark monetary attribution

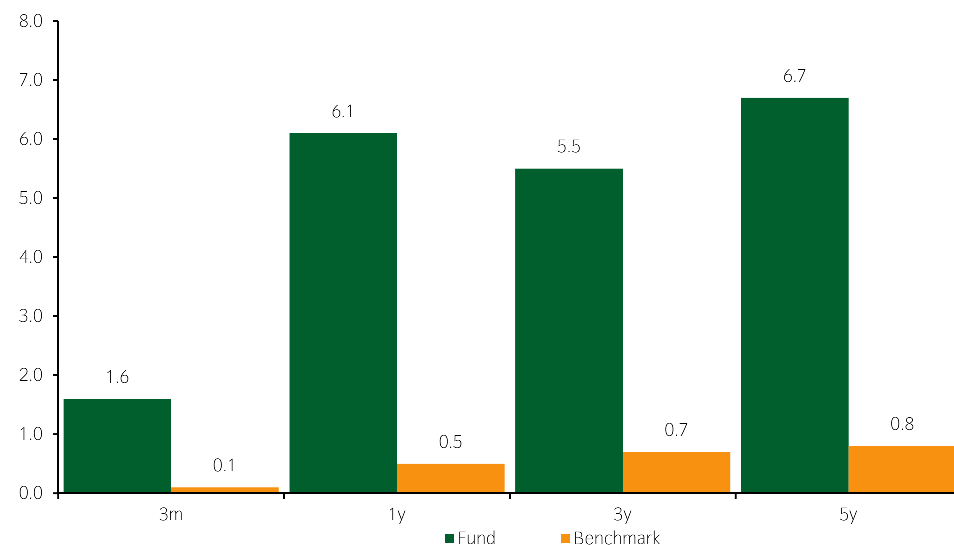


Description	YTD (£)
Interest Rates	-10,982,423.79
Gilt Spread to Swap	806,962.84
Credit	-186,250.76
LPI vs RPI (Vols)	0.00
Inflation	39,714,845.94
Gilt Inflation Spread to Swap	-4,269,416.93
Carry	2,886,947.57
Other	-3,004,919.46
Benchmark Return	24,965,745.42

All figures are calculated geometrically

Libor Plus Fund

Fund performance as at 31 December 2013



Benchmark refers to iBoxx Sterling Non-Gilt All Maturities index. Source: Russell/Mellon CAPS, Rimes. Performance of the Fund is on an offer basis with income reinvested and gross of management charge. Performance for periods over one year is annualised

Fund Manager Comments

The Fund outperformed its benchmark during the fourth quarter of 2013 and the running carry remained strong, ending the period at Libor +202bps. The final quarter of the year was strong for the European asset-backed security (ABS) market as both macro-economic and technical factors remained supportive. The market continued to be under-supplied due to a combination of regulatory pressures (e.g. the UK's Fund for Lending Scheme) and uneconomic liability spreads (i.e. underlying mortgage rates are lower than funding costs) which have resulted in issuance levels that are unable to match demand. The Fund's core longs remained focused on the UK residential mortgage-backed securities market, the commercial mortgage-backed securities market and the collateralised loan obligation market. The new issue market was busy in October and November with the most diverse range of issuance since pre-crisis and the Fund invested in many of these transactions. Our outlook for 2014 is for continued gradual normalisation of the asset class as a new equilibrium is found. The fundamental story for ABS remains unchallenged: the vast majority of ABS assets in Europe have performed exceptionally yet spreads are well above their pre-crisis levels. The technical story continues to gather strength as the asset class is not yet issuing paper to match note redemptions and the growing global demand for the asset. Ironically for an asset class that was a key catalyst of the great recession that started in 2008, we believe the risks to the performance of the ABS going forward are more likely to stem from renewed macro concerns or policy errors as opposed to any ABS-specific negative news.

Libor Plus Fund Continued

Credit Rating Breakdown of Non-Government Positions

AAA	52.0
AA	48.0

Jurisdiction (% of Fund)

UK	34.3
Netherlands	7.9
US	1.8
Germany	5.9
Spain	7.5
Italy	6.3
Ireland	0.8
Portugal	1.6
France	0.8
Sweden	1.5
Pan-Europe	8.5
Belgium	0.3
Australia	20.0
Cash	2.9

Maturity Profile (in weighted average life, %)

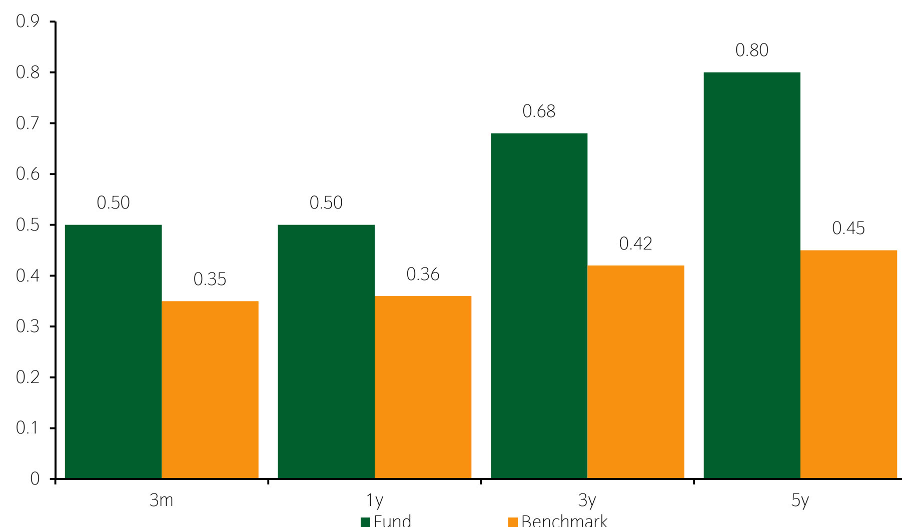
Less than 0.5 years	3.3
0.5 to 1 year	3.9
1 to 1.5 years	4.0
1.5 to 2 years	2.1
2 to 3 years	14.4
3 to 4 years	17.3
4 to 5 years	26.6
5 to 6 years	28.7

Asset Backed Securities (% of Fund)

Prime RMBS	57.2
Buy to Let	2.3
Leveraged Loan CLO	8.2
SME CLO	0.3
CMBS	11.4
Cash	2.9
UK Non-conforming RMBS	17.7

Insight Liquidity Sterling Fund

Fund performance as at 31 December 2013



Benchmark refers to 7 Day GBP Libid. Source: Insight Investment. Basis: Annualised total return, gross of all fees and expenses.

Fund Manager Comments

- The Fund returned 0.50% over the quarter on an annualised basis, gross of fees, outperforming its benchmark, 7-day sterling Libid, which returned 0.35%. The Fund's duration and yield curve positioning were positive for returns relative to the benchmark. Activity was relatively light through the quarter. Improving economic data continued to drive speculation that the Bank of England may raise interest rates sooner than previously expected, but the Bank's governor Mark Carney reiterated that this was unlikely based on economic forecasts. Trading focused largely on highly liquid, short-dated instruments. The Fund primarily made additions to the certificates of deposit and commercial paper portfolio from bank issuers, along with selective additions to the floating rate note and bond portfolios. The weighted average maturity of the Fund was 39 days at the beginning of the quarter and fell slightly to 38 days by the end of the period.

Insight Liquidity Sterling Fund Continued

Fund Breakdown by Asset Class

Certificates of deposit	45.2
Commercial paper	25.5
Corporate floating rate	3.1
Corporate Bond	0.2
Time deposits and cash	23.6
Supranational	0.2
Repurchase agreement	2.1
Government Bond	0.2

Top 10 holdings

Call Account Lloyds	9.2
Z/C CP Kreditanstalt Fur Wiederaufbau 12.02.2014	3.8
TD Banques Populaires Caisses d'Epargne 0.43% 31.12.2013	3.2
Call Account Credit Agricole Corp and Inv Bank	2.6
TD Deutsche 0.44% 31.12.2013	2.5
Repo HSBC 0.25% 30.12.2013	2.1
Z/C CP Bank Nederlandse Gemeenten 28.04.2014	2.1
Z/C CP Bank Nederlandse Gemeenten 07.02.2014	1.8
TD ING 0.43% 31.12.2013	1.5
Z/C CP Sumitomo Mitsui Banking Corp 27.01.2014	1.5

Credit Rating Breakdown

A1+	70.1
A1	29.9

Maturity Profile

1 day	25.4
2-7 days	6.6
8-30 days	19.1
31-90 days	38.5
91-180 days	9.8
181 days +	0.7

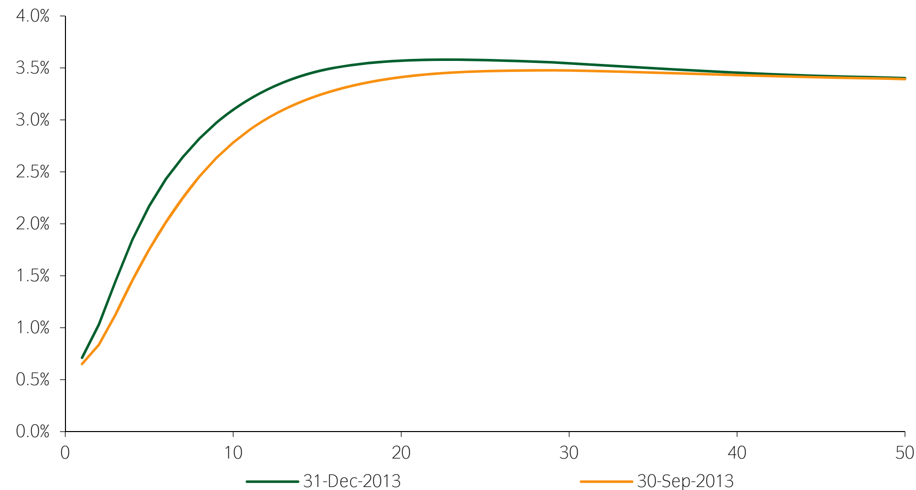
Investment Analysis

DORSET LIABILITY MATCHING PORTFOLIO

For the period 01 October 2013 to 31 December 2013

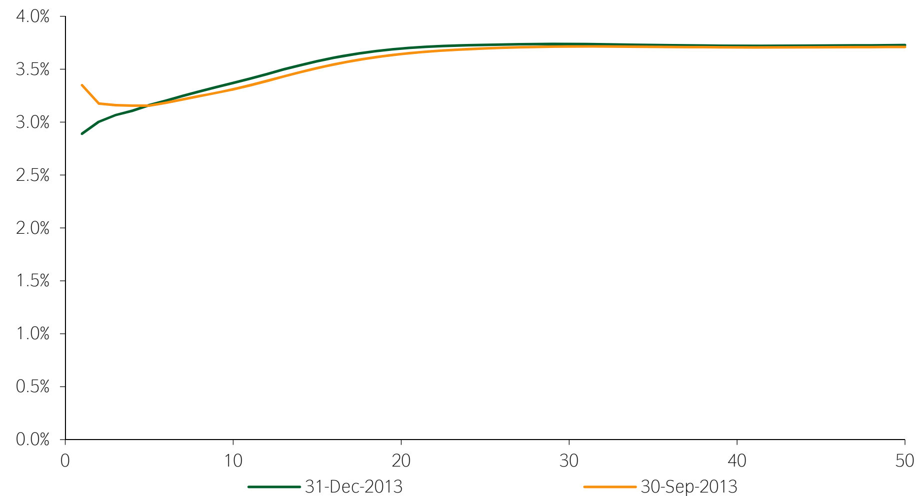
Sterling LDI

Interest rate swap rates (%)



Source: Xenomorph broker quotes composite

RPI swap rates (%)



Source: Xenomorph broker quotes composite

Market review

- Gilt markets continued to be largely influenced by events in the US. October's US Government shutdown meant US economic releases came to a standstill, leaving the gilt market without clear direction. The eventual debt ceiling extension saw yields rise across the curve, despite it doing little more than extending uncertainty until February.
- Yields fell slightly in the wake of the ECB's decision to cut rates to a record low of 0.25%, but subsequently rebounded following the minutes from the US Federal Reserve's November FOMC meeting which brought forward tapering expectations.
- Despite accelerating growth in the UK economy, the Governor of the Bank of England, Mark Carney, suggested that monetary policy would remain loose for the foreseeable future.
- Throughout the quarter, the BoE kept rates constant at 0.50% and Quantitative Easing (QE) unchanged at £375bn.
- Conventional z-spreads climbed c.2-4bp across the curve, whereas index-linked z-spreads fell at the short end of the curve and rose slightly at the long end.
- Real swap rates rallied across the curve, with the most noticeable rise coming at the short end and the 20 year point experiencing an 11bp climb to -0.10%.
- Interest rates also rallied across the curve, with the 20 year tenor swap rate rising 16bp to 3.59%.

Money Market Bulletin – UK

Market review

- Economic figures released over the quarter were generally positive with continued growth across the services, manufacturing and construction sectors. The Bank of England estimates growth for Q4 at 0.9%.
- The latest data showed the CPI measure of inflation declined from 2.7% to 2.1%.
- 1-month sterling Libor remained unchanged over the quarter at 0.49% while the 3-month Libor rate rose slightly from 0.52% to 0.53%. Gilt yields also increased: 2-year gilt yields rose from 0.42% to 0.58%.

Fixed Income Market Review

UK

At the beginning of the period, gilt yields held steady despite better economic news but in November and December yields trended higher, leading total returns for the quarter into negative territory. Yields were driven higher by the improvement in both UK and global economic data. The gilt market was also partially driven by global concerns, including the anticipated 'tapering' of the US quantitative easing programme. Yields rose across the curve, with the biggest moves seen in 5 to 15-year maturities. The 10-year gilt yield ended the period at 3.02%, its highest level since July 2011.

Chart 1: UK GDP Level

Source: Datastream

In inflation-linked gilts, yields also rose over the quarter. The biggest moves were at the short end, with 5 to 10-year maturities rising the most, while at the very long end 50-year maturities were almost unchanged. The break-even inflation rate rose from 3.28% to 3.41% over the quarter, perhaps in response to the stronger economic data.

The UK economy showed signs of continued strength over the quarter. GDP was reported to have grown 0.8% in the third quarter, the fastest pace in three years, mainly due to a pick-up in consumption. The OECD increased its forecast for UK growth for the year to 1.4%. The growth appeared to be widespread with improvements seen in both manufacturing and services sectors. UK manufacturing picked up further in November to its strongest level for almost three years, boosted by strong new order figures. Britain's services sector expanded at its fastest rate since May 1997 in October, raising the prospect of another rise in economic growth in the final three months of 2013. Elsewhere, inflation continued to fall, as UK CPI dropped to 2.1% in November, its lowest rate for four years, due to slower increases in food and energy prices. Employment figures also showed a positive trend, as the November unemployment rate fell to 7.4%, the lowest since 2009. The Bank of England's Monetary Policy Committee said recent news suggested the UK was experiencing a "sustained recovery". There was however no change to monetary policy over the quarter, with core interest rates held at 0.5% and the asset purchase scheme at £375 billion.

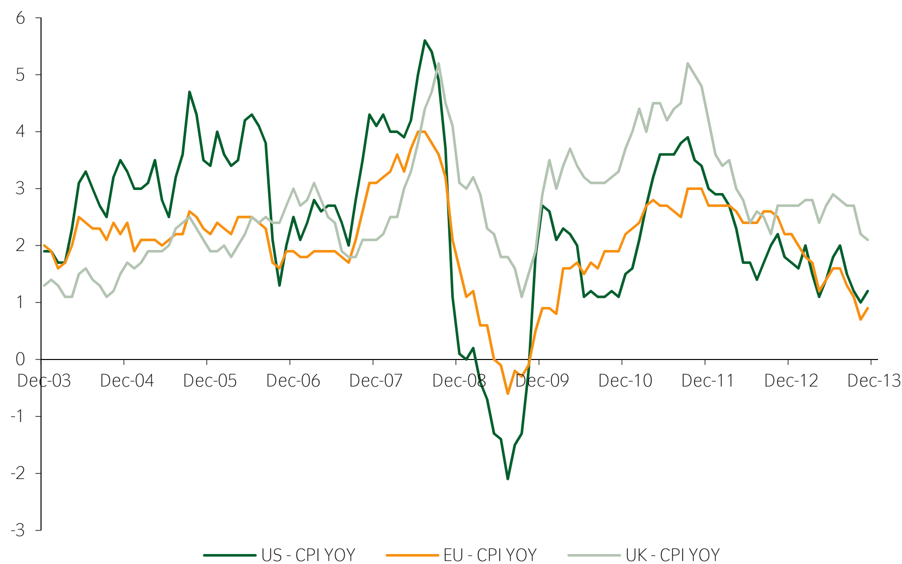
US

US treasuries made a negative return over the quarter. Yields rose across the curve, with the biggest moves seen in 5 to 10-year maturities. The 10-year treasury yield ended the quarter at around 3.0%. The period began strongly for treasuries, as market attention was focused on political negotiations over the federal budget and debt ceiling, which led to a shutdown of many routine federal functions until politicians agreed a last-minute temporary resolution. Later in the quarter, treasuries started to weaken as the US economy showed signs of continued growth. Headlines remained focused on Federal Reserve (Fed) policy after it signalled in the

Fixed Income Market Review Continued

summer that it would reduce the size of its quantitative easing (QE) programme as the economy recovered. In mid-December, in response to the stronger data, the Fed announced a modest tapering of the QE programme, reducing it from $85 billion to $75 billion per month from January. Bond prices fell slightly as a result, but overall the markets took the announcement calmly. At the same time, the Fed stated that the federal funds rate is likely to remain at the same level well beyond the time that the unemployment rate falls below 6.5%, particularly if inflation remains below the target rate.

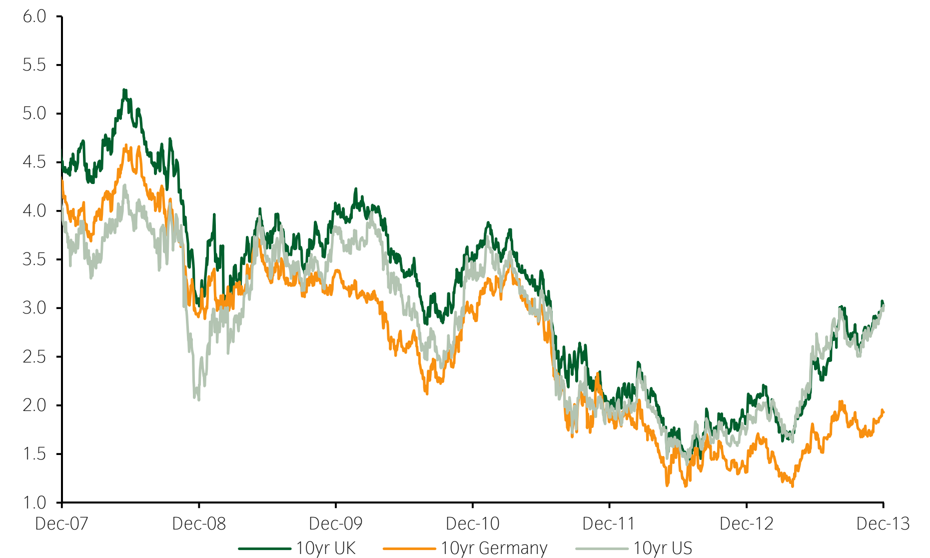
Chart 2: US, Europe, UK CPI inflation (%)



Source: Bloomberg

Economic data over the quarter continued to indicate that the US economy is returning to trend growth. The final estimate for GDP growth in the third quarter was 4.1% (annualised), which was well above expectations. GDP was boosted by strong growth in personal consumption and also a build-up in inventories. Manufacturing growth was lacklustre in October but then unexpectedly accelerated in November. Services activity expanded again in November after a sharp decline in October as a result of the temporary government shutdown. Inflation over the year to November rose by 1.2%, up slightly from the 1.0% rise over the year to October, but still below the Fed's 2% target rate. The unemployment rate fell from 7.3% in October to 7.0% in November.

Chart 3: UK, German and US 10-year government bond yields (%)



Source: Bloomberg

Europe ex UK

Core European government bonds made a negative return over the quarter, following other global bond markets. Yields rose across the curve, with the biggest moves seen in 6 to 9-year maturities, although longer-maturity bonds also moved higher. The 10-year German bund

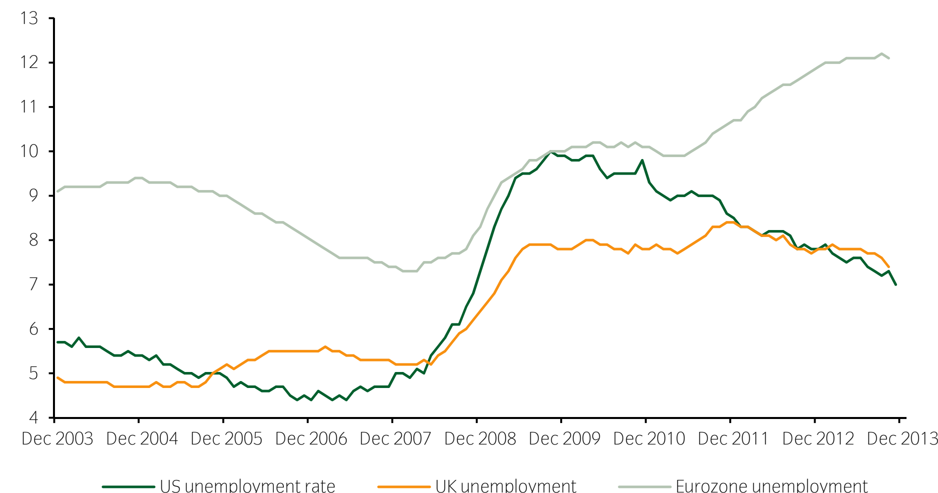
Fixed Income Market Review Continued

ended the quarter at 1.92%. Core bond prices initially strengthened, as European economic data showed little sign of improvement. Towards the end of the period core bond prices followed other global markets lower on the news that the US Federal Reserve was beginning to taper its asset purchase programme.

Peripheral bonds outperformed core bonds over the quarter. Spreads tightened as the economic and political situation in the periphery continued to stabilise. Spanish 5-year yields fell over 40 bps as the country emerged from a two-year recession and also registered a current account surplus. Italian 5-year yields fell by a similar amount as demand for the country's bonds increased. Elsewhere, in December Ireland became the first country to leave the international bail-out programme, due to the success of its austerity programme.

In November, the European Central Bank (ECB) cut its primary interest rate to 0.25%, a record low. ECB president Mario Draghi cited the weak recovery among other factors for the decision; later in the month, data showed that eurozone GDP growth in the third quarter was only 0.1%. There was a divergence in performance between the two largest economies, as Germany grew by 0.3% while France contracted by 0.1%. The ECB maintained its expectation of a 0.4% contraction in the eurozone economy for 2013. From a policy perspective, the combination of weak economic growth and low inflation make it likely that the ECB will keep interest rates at current historically low levels for the foreseeable future. The annual rate of consumer price inflation increased from 0.7% to 0.9% in November. The ECB reduced its inflation forecasts slightly for 2014 and 2015 to 1.1% and 1.3% respectively, well below the 2% target rate. There was speculation that the ECB would take further steps to stimulate growth, however, Mario Draghi said later in December that there were encouraging signs in the eurozone economy, and he saw no "urgent" need for a further rate reduction.

Chart 4: UK, US and Eurozone unemployment rates (% yoy)



Source: Datastream

Emerging market debt

Emerging market debt had another volatile quarter, driven primarily by movements in US treasuries. October was a positive month for risk assets. After markets rebounded in September due to expectations that the Federal Reserve would delay tapering its quantitative easing programme until 2014, the rally was boosted further in October once the negotiations over the US government shutdown and debt ceiling were resolved. Emerging market assets were under pressure in November, as expectations that the Federal Reserve (Fed) would taper quantitative easing were brought forward yet again after better-than-expected US economic data. The rise in US Treasury yields overwhelmed other positive developments that would normally support a more positive risk climate for emerging markets including greater-than-expected zeal for reform in China. It seemed the main themes from this summer's selloff were present again as emerging market debt underperformed other global

Fixed Income Market Review Continued

fixed income assets, with countries that have the most precarious balance-of-payments positions suffering the most. In December global bond markets took the long-awaited announcement on tapering calmly. The reaction in the emerging market universe was slightly more muted, as it continued to trade with little conviction and as outflows from the asset class continued to be the main driver of emerging market debt sentiment.

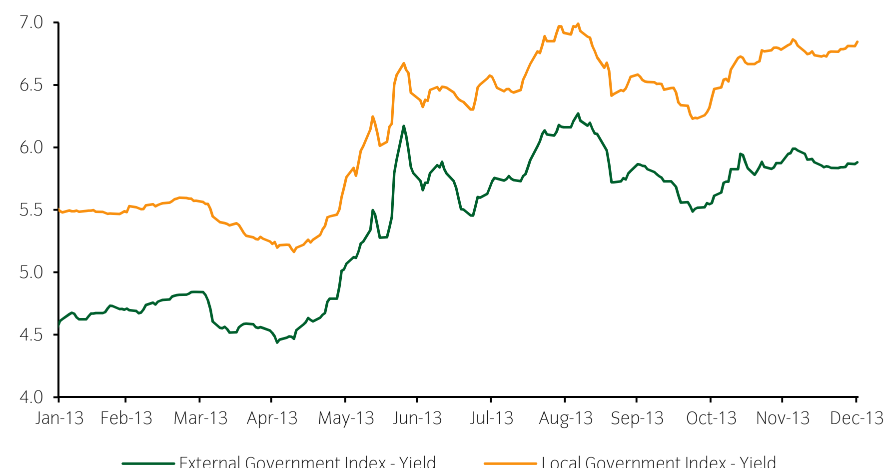
Despite the volatility over the quarter, external sovereign debt ended the quarter in positive territory, with the JP Morgan EMBI Global Diversified up 1.53% in USD terms. Spreads over US treasuries tightened, ending the quarter at 308bps, down from 340bps. By region the Middle East was the strongest performer, and Latin America the weakest. External corporate bonds followed a similar pattern, with the JP CEMBI Broad Diversified rising 1.96% in USD terms. Bonds denominated in local currency struggled, given the continuing weakness in many emerging market currencies; the JP Morgan GBI-EM Global Diversified index fell 1.54% over the quarter.

High yield

High yield markets produced a positive return over the quarter, supported by strong demand as investors continued to look for income and retail fund inflows increased 20%. Western European high yield spreads tightened 87bps to 395bp over the period, well below the long term average but still above the tights seen in 2007. Yields ended the period at 4.85%, an unprecedented level. US average spreads tightened by 67bps to 436bps, with yields declining to 5.77%. Credit curves flattened over the quarter.

The new issue market continued to be very active, with European issuance reaching record levels. As the market has grown, issue size has generally decreased, with many smaller names from peripheral Europe in particular coming to the market. New issues were heavily oversubscribed due to strong retail fund flows and investors' high cash levels. In the US, issuance in 2013 remained at a similar level to 2012, with retails fund flows being more muted compared with 2012.

Chart 5: Emerging markets external government and local government yields



Source: Bloomberg

In both the US and Europe the excessive demand for high yield bonds has led to a general deterioration of credit quality, with companies able to issue bonds at higher leverage multiples and weaker covenants including PIK (payment in kind) notes deals. Default levels remain very low as companies have taken care of maturities coming due and are awash with liquidity. The 12-month trailing default rate fell to 1.34% in November, and recovery rates remain above average. US mutual fund flows into high yield bonds slowed considerably as fund flows have been diverted into loans in anticipation of higher government bond yields.

Loans

The loans market made a positive return over the quarter. In October there was little news but the market drifted higher as demand continued to be strong. During the year we have seen an increase in cross-border US-European deals generated by corporates rather than private equity

Fixed Income Market Review Continued

firms. Corporate fundamentals remain strong, however, and default rates have been on a downward trend since the beginning of the year, falling from 6.1% to 2.9% over 2013.

The new issuance market remained buoyant, with 22 deals totalling €7.4 billion in November and 9 issues totalling €1.47 billion in December. 2013 was a significant year for new issuance with €67.4bn of new European loan issuance compared to €28.6bn in 2012. There was also €7.4bn of new European collateralised loan obligation (CLO) issuance across 20 new vehicles during 2013 compared to negligible issuance in recent years. This supported market technicals as increasing numbers of vintage CLOs exited their reinvestment periods.

Asset-backed securities

The European asset-backed securities (ABS) market performed strongly in the fourth quarter. The market was supported by improving macro-economic data and also by attractive technicals: the market is undersupplied because of regulatory pressures and mortgage rates often being lower than funding costs, and so new issuance is not meeting demand. The strongest performers were in the more esoteric sectors, where the compression between higher and lower beta credit continues. These included peripheral issues, in particular from Spain.

The ABS new issue markets were very active in October and November. New issuance was at its most diverse since the financial crisis and included German multi-family, UK and Swedish non-conforming, French and German auto and residential mortgage-backed securities (MBS) from Australia, the UK and the Netherlands. November also saw the return of new issues from the peripheral countries, with MBS issued in Ireland and Italy, and we expect there will be more to come. December was a quiet month with no new issues and thin trading.

Currency

During the fourth quarter of 2013, currency markets were driven by concerns over the Fed's intention to reduce its quantitative easing programme, which in turn drove US and global bond yields.

Early in the quarter, cyclically sensitive currencies generally strengthened as markets waited for the US government shutdown to be resolved. At the same time, the US dollar (USD) weakened as the perception grew that the economic impact of the government shutdown would prevent the Fed from beginning to reduce QE until 2014. However, US economic data was subsequently stronger than expected, leading investors to expect the Fed to reduce its QE programme earlier. This proved supportive for the USD against a range of currencies, and sentiment remained positive towards the USD when the Fed announced it would reduce QE from January.

It was a strong quarter overall for the USD against several currencies. Emerging market currencies, including the South African rand and Turkish lira, generally declined against the USD over the quarter as US bond yields rose. The Japanese yen (JPY) also declined as the Bank of Japan remains committed to substantial quantitative easing, and the Australian dollar (AUD) weakened as concerns of weakening demand for commodity exports from China weighed on the currency. The euro and sterling strengthened slightly over the period.

Investment Grade credit

The total return on UK credit was broadly flat on the quarter. Excluding the negative impact of rising gilt yields, the excess return of the Merrill Lynch Bank of America UK non-gilt index was 1.4%. Euro-denominated credit markets produced positive numbers both including and excluding the impact of government bond markets. Investment grade credit spreads continued their narrowing trend over the quarter. Overall, UK credit spreads narrowed by 20bps and European credit spreads by 10bps. Corporate bond yields, having reached decade-lows in the second quarter of 2013, ended the year at 4% in the UK and 2% in Europe. As investors continued their search for yield, lower-rated issues

Fixed Income Market Review Continued

outperformed higher-rated issues. As a result, investment grade credit curves flattened and the difference in spreads between BBB and AAA credits is now back to early 2008 levels.

The new issue market continued to be active over the quarter, with many new issues coming in at more attractive prices than secondary issues and hence being oversubscribed. There was increased issuance of hybrid bonds and contingent convertibles from banks. Over 2013, total new issuance in sterling was £38.5 billion, down from £49.3 billion in 2012. Of this 2013 total, £21.4 billion was in corporate bonds and £17.1 billion in financials, although if maturing financial bonds are taken into account, net issuance in financials was negative.

Financials outperformed corporates over the quarter. Within financials, subordinated insurance and senior banks were the best performers. Within corporates, telecoms were the best performers, as many of these companies have completed restructuring processes. There continues to be company-specific news in the telecoms sector, with a number of companies disposing of assets (in order to maintain their investment grade credit rating), whilst others are looking to grow their businesses through acquisitions. Telecom Italia, meanwhile, was downgraded to high yield by all three ratings agencies during the quarter, and rallied on the news. Real estate and utilities underperformed. Corporate earnings were generally solid, but financials were more mixed.

Chart 6: GBP, EUR and USD credit spreads

Source: Merrill Lynch, Bloomberg

Investment Outlook

DORSET LIABILITY MATCHING PORTFOLIO

For the period 01 October 2013 to 31 December 2013

Money Market Bulletin – UK

Outlook

- Recent UK data has been strong enough to suggest the economy is gaining momentum. We view the rapid improvement in activity as linked to the Funding for Lending scheme, the dovish policy stance of Bank of England Governor Mark Carney, and the more optimistic tones emanating from the Bank.
- The upswing reduces the chances of additional stimulus, but with credit availability improving, we expect to see a rebound in capital investment in 2014 so long as firms see opportunities for attractive returns.

Fixed Income Outlook

UK

The UK continues to enjoy positive tailwinds, with sequential improvements in housing and labour markets feeding through into rising indicators of household and business confidence. The new Bank of England Governor Carney began his tenure by giving forward guidance targeting the unemployment rate at 7%. However, over the past months the labour market has improved rapidly, bringing forward expectations of a rate hike. Carney reacted by emphasising that the 7% was a threshold, rather than a trigger for tighter policy. For now, credit availability is improving and we expect the recent more positive trends may continue looking into 2014. The upwards movement in yields over 2013 now mean that a lot of bad news is already priced in, despite there being no prospect of rate hikes in the near future.

Europe ex UK

In mainland Europe activity remains subdued and we expect 2014 growth to improve but remain sub-par. We expect the ECB's Asset Quality Review will continue to restrain bank lending, which will weigh on activity. The ECB could attempt to counterbalance some of this effect through some form of credit easing. More aggressive forms of easing, such as quantitative easing, still face stiff opposition from policy hawks. That said, there is a growing recognition that monetary policy needs to feed through to the real economy while the banking sector continues to recapitalise. The peripheral economies that experienced sharp contractions and implemented reforms are now seeing some recovery. The notable exception is France, which has yet to tackle the burden of its large public sector.

Given the ECB's stance on monetary policy, we expect German bund yields to continue to trade at around year end levels, outperforming US treasuries and most other developed markets. We expect the front end to be anchored and the yield curve to remain steep. As risks diminish and the environment remains highly liquid, we forecast that peripheral bond yields will continue to fall.

US

The outlook for the US economy has improved in recent months with stronger growth, falling unemployment and low inflation. The political backdrop has also changed significantly with a budget agreement and lower probability of a fight to raise the debt ceiling next year. If growth continues to improve, we expect the recently announced tapering of the asset purchase programme to come to an end in mid-2014. The proposed new chairman of the Fed, Janet Yellen, is widely perceived as a 'dove' with regards to monetary policy and so we do not expect any interest rate rises before mid-2015.

Despite the extent of the rise in yields in 2013, we expect them to continue to edge higher in 2014, with the 'belly' of the curve likely to underperform as the tightening cycle approaches. The sell-off at the long end should be more muted as inflation is likely to remain low and the improvement in the fiscal balance will lead to lower net treasury issuance.

Emerging market debt

We believe that emerging market debt has better fundamentals than is currently being priced in by markets. However, the timing of a higher net long allocation to the asset class would depend mostly on technical factors, in particular flows into the asset class and net issuance. Outflows from the emerging market universe were the main barometer of investor sentiment towards the asset class in 2013, even though they were mostly from retail funds. Institutional fund flows remained stable and were also more than covered by coupon and principal payments. In addition, an increase in negative political headlines (protests in Thailand, Turkey and Ukraine, for example) could increase the political risk premia for the asset class overall, particularly as 2014 is a big electoral year in emerging markets, with 18 countries holding major elections.

Fixed Income Outlook Continued

Investment grade credit

We believe that that current environment for credit continues to be supportive: corporate balance sheets are generally strong and the default rate is low. Default rates are not expected to go up as funding costs are likely to remain manageable. In addition, investment grade credit is still seeing strong inflows. Given this backdrop, we believe spreads in investment grade credit remain attractive. At these levels investors are more than compensated for default risk and other non-default risks such as volatility. Spreads could tighten further as investors continue to search for yield. High yield bonds are much closer to all-time tight spreads and so do not offer much strategic value, although leveraged loans remain attractive.

Stock selection remains very important in this environment as there is little pricing differentiation between fundamentally strong companies and weak ones. We are focusing on investing in strong credits, with robust business models, and in which we have access to management. Ultimately we are positioning portfolios to have core holdings in issuers that we are happy to hold through the credit cycle. In the event of increased market volatility, we want to ensure we are not a forced seller. Given cheap borrowing levels, we are continuously screening for merger and acquisition or leveraged buy-out risk, which could cause a rise in corporate leverage. The main risk to credit markets is a renewed sharp decline in global growth rates or, to a lesser extent, a further rise in government bond yields. Liquidity in the market is much lower than it used to be and has not yet been tested under difficult trading conditions.

High yield

Given the strong performance and yield compression of the high yield market, we expect that high yield total returns in 2014 will be lower than in 2013. Interest rate risk continues to be the largest threat to fixed income, whilst new issue supply coupled with low cash balances and fund flows will drive the direction of the market going forward. There is likely to be increased volatility associated with movements in government bond yields, particularly in the US. Demand for lower rated credit may decline in a rising Treasury yield environment.

Although the credit environment remains benign, we expect credit quality to deteriorate marginally from here, as leverage levels are high and companies are becoming more aggressive with their balance sheets. The lack of new issues and high cash balances of investors has caused a supply shortage in short dated paper and bid/offer spreads remain elevated. However, we are still finding value in selected pockets of the market. Short dated high yield remains a compelling investment as it provides the most optimal risk adjusted method of investing in this asset class given the overall yield compression.

Asset-backed securities

Our outlook for 2014 is for a continued gradual normalisation of the asset class until a new equilibrium is found. The vast majority of ABS assets in Europe have performed exceptionally and yet spreads are still well above their pre-crisis levels. The technical story continues to gather strength as the asset class is not yet issuing enough paper to match note redemptions and the growing global demand for ABS. The risk to this outlook will be renewed concerns about macro-economic growth or monetary policy errors.

We continue to have a stable outlook over the medium term and to believe that the long term strategic value of the asset class remains exceptionally strong. Stock-picking remains very important and our core long positions include: the UK residential MBS market, because of the combination of improving economic data and the government support for the housing market; the commercial MBS market, which is likely to see better refinancing conditions and the CLO market, trading at cheap levels because of regulatory uncertainty which we expect to soon be resolved.

Fixed Income Outlook Continued

Loans

The loan market remains in good shape with its technical strength highlighted by the fact that prices remained firm even when there was a slight weakness in high yield. We have seen improved deal flow in the second half of the year both in terms of volume of deals and the quality of the businesses launched which has supported our investment activity. There has been an increase in weaker deals and rescue financings, so stock selection remains key.

In 2014, the market is likely to continue to be buoyant, with €100bn of European institutional issuance and €8-15bn of CLO issuance forecast. We expect the market to be supported by declining default rates, low sensitivity to rate moves and positive market technicals.

Currency

Looking ahead, we think the gradual winding down of the Fed's bond purchases under its QE programme will continue to put upward pressure on bond yields. This in turn will be supportive for the USD versus the JPY and AUD. Emerging market currencies will likely continue to weaken as yields elsewhere become more attractive for investors. The main risk to this scenario comes from US economic data. Any significant weakening in economic data would increase the likelihood of policy easing by the Fed and would probably lead yields to fall and the USD to weaken.

Appendices

DORSET LIABILITY MATCHING PORTFOLIO

For the period 01 October 2013 to 31 December 2013

Summary Portfolio Valuation

As at 31 December 2013

	Book Cost GBP	% of Total Book Cost	Market Value GBP	% of Total Market Value
Fixed Income				
Sterling				
Investment Funds	147,957,061.56	100.00	193,464,214.98	100.00
Total Sterling	147,957,061.56	100.00	193,464,214.98	100.00
Total Fixed Income	147,957,061.56	100.00	193,464,214.98	100.00
Total	**147,957,061.56**	**100.00**	**193,464,214.98**	**100.00**

Notes

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