Quarterly Report 31 December 2013

Dorset County Pension Fund

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YOUR PORTFOLIO

Fund performance objective

The fund objective is to outperform the benchmark by 0.5% 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)
31 December 2013	190.25
30 September 2013	188.68
Change over quarter	1.57
Net cash inflow (outflow)	0.28

EXECUTIVE SUMMARY

Performance

- Your fund gave a gross return of 0.68% over the quarter, compared with a benchmark return of -0.23%, bringing performance year to date of the fund and its benchmark to 2.84% and 0.24% respectively.
- Credit sector and stock selection were the main drivers of performance.

The economy and bond markets

- Investor sentiment remained positive in response to a degree of rapprochement in US politics, less concern about the prospect of US Federal Reserve (Fed) policy tightening, better economic data trends, and no significant deterioration in Emerging Market prospects. In the UK, gross domestic product (GDP) rose by 0.8% in the third quarter, with indications that the momentum continued into quarter four. Consumer confidence, mortgage approvals and house prices have risen, while unemployment has fallen to 7.4%.
- October's government shutdown in the US had only a temporary effect on activity, with consumer confidence rebounding and business surveys remaining firm. Although remaining high, the unemployment rate has fallen. After widespread speculation, the Fed surprised markets and signalled its intention to taper quantitative easing purchases. Eurozone GDP has remained weak, rising by a mere 0.1% in the third quarter. Reflecting the subdued outlook for inflation, the European Central Bank reduced its main refinancing rate to 0.25%. In Asia, Japanese GDP growth slowed to 0.3% for the third quarter, while, in China, GDP growth rose to 7.8% for the year.
- Conventional gilts returned -1.35% over quarter four, with the 10 year yield rising to 3.0%. Issuance was concentrated between 5 and 10 year maturities. Medium dated gilts underperformed long and short dated gilts on a risk adjusted basis. Real yields generally rose throughout the quarter, producing a -0.89% return for index linked gilts. The 5 to 10 year sector saw the largest real yield moves on the quarter. Breakeven inflation rates fell sharply as inflation undershot forecasts. Sterling investment grade credit bonds returned –0.02%, outperforming government bonds. Insurance and bank bonds remained the best performing areas, while supranational and covered bonds underperformed. All sectors saw a narrowing of credit spreads. Global high yield bonds returned 3.5% over the quarter.

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.

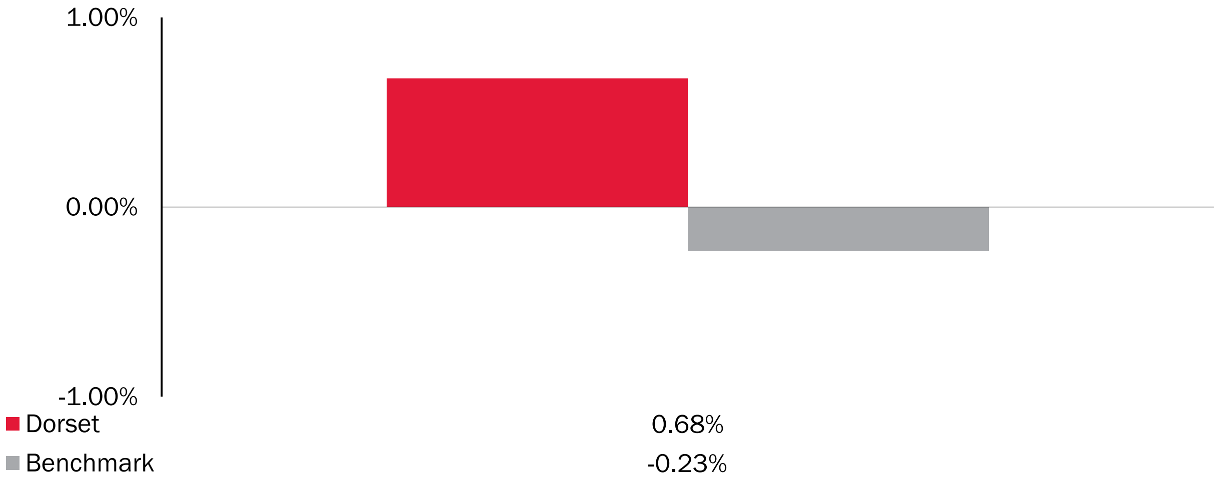
FUND PERFORMANCE

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 (%)
Q4 2013	0.68	-0.23	0.91
Year to date	2.84	0.24	2.60
Rolling 12 months	2.84	0.24	2.60
3 years p.a.	12.49	12.09	0.40
5 years p.a.	12.38	7.83	4.55
Since inception 02.07.07p.a.	9.11	9.65	-0.54

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 4 2013

Asset split

	Fund (%)	Benchmark[1] (%)
Conventional credit bonds[2]	100.0	99.1
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	0.9
Foreign index linked sovereign	0.0	0.0
Derivatives	0.0	0.0

Fund data

	Fund	Benchmark[1]
Duration	9.7 years	9.6 years
Gross redemption yield[3]	4.95%	4.32%
No. of stocks	364	725
Fund size	£190.3m	
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.

Performance

	Fund (%)	Benchmark[1] (%)	Relative (%)
Q4 2013	**0.71**	**-0.23**	**0.94**
Year to date	2.64	0.24	2.40
Rolling 12 months	2.64	0.24	2.40
Since inception p.a. (acc) 02/07/2012[2]	8.98	6.11	2.87

1 Benchmark: iBoxx Sterling Non-Gilt Over 5 Year Index.

2 The fund launched 02.07.2007 but its benchmark and objective changed on 02.07.2012. Performance prior to 02.07.2012 has therefore been omitted. If you require performance prior to this change, please contact your client service manager.

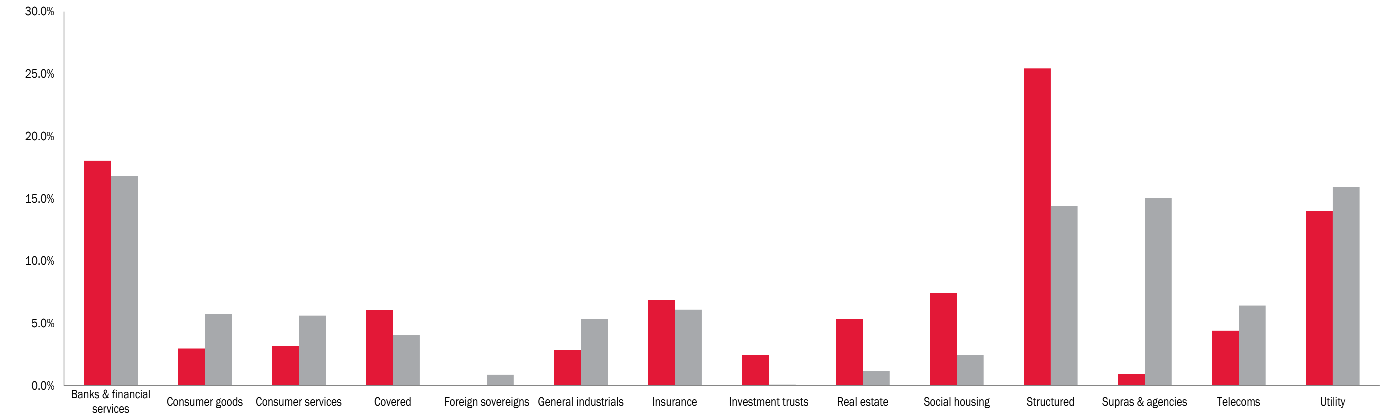
The fund objective is to outperform the benchmark by 0.5% per annum gross of the standard management fees.

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 4 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	18.0%	3.0%	3.2%	6.1%	0.0%	2.9%	6.9%	2.4%	5.4%	7.4%	25.4%	1.0%	4.4%	14.0%
Benchmark	16.8%	5.7%	5.6%	4.0%	0.9%	5.4%	6.1%	0.1%	1.2%	2.5%	14.4%	15.0%	6.4%	15.9%

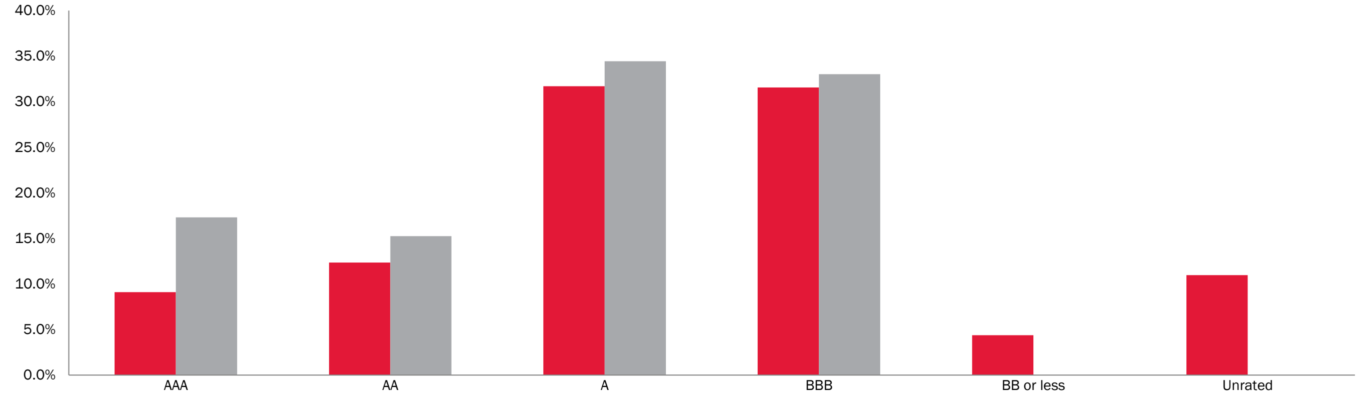
Source: rlam. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio.

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, a significant underweight exposure versus the benchmark index.	Sovereign and supranational bonds lagged the wider credit market. Supranational bonds gave their weakest annual absolute return for the sector in over 15 years.	The underweight position in sovereign and supranational bonds was beneficial to performance.
We continued to prefer a combination of covered bank bonds and subordinated bank debt to senior bonds.	Although the magnitude of the position was reduced, we maintained an above benchmark exposure to subordinated bank debt.	Subordinated financial bonds continued to outperform strongly over the quarter, and over the year as a whole, supported by improving balance sheets and on-going buy backs. Having rebounded in quarter three, covered bonds again lagged the wider sterling credit market.	Despite the performance of covered bonds, the strong returns achieved by subordinated bank debt was the dominating factor benefitting fund performance.
We thought that high profile consumer orientated bonds were unattractively priced relative to corporate debt	We maintained an underweight exposure to such bonds.	Consumer orientated bonds outperformed UK government securities but underperformed the wider sterling credit market.	The low weighting in high profile consumer debt was beneficial to performance.
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.	ABS marginally lagged the wider sterling credit market although remained the strongest performing sector over 2013 as a whole, outside of the financial sectors.	The exposure to secured and ABS bonds was a broadly neutral factor. Over the year the sector exposure has been significantly beneficial to performance.

RLPPC OVER 5 YEAR CORPORATE BOND FUND

Quarter 4 2013

Rating breakdown



	AAA	AA	A	BBB	BB or less	Unrated
PPLCP	9.1%	12.3%	31.7%	31.5%	4.4%	11.0%
Benchmark	17.3%	15.2%	34.4%	33.0%	0.0%	0.0%

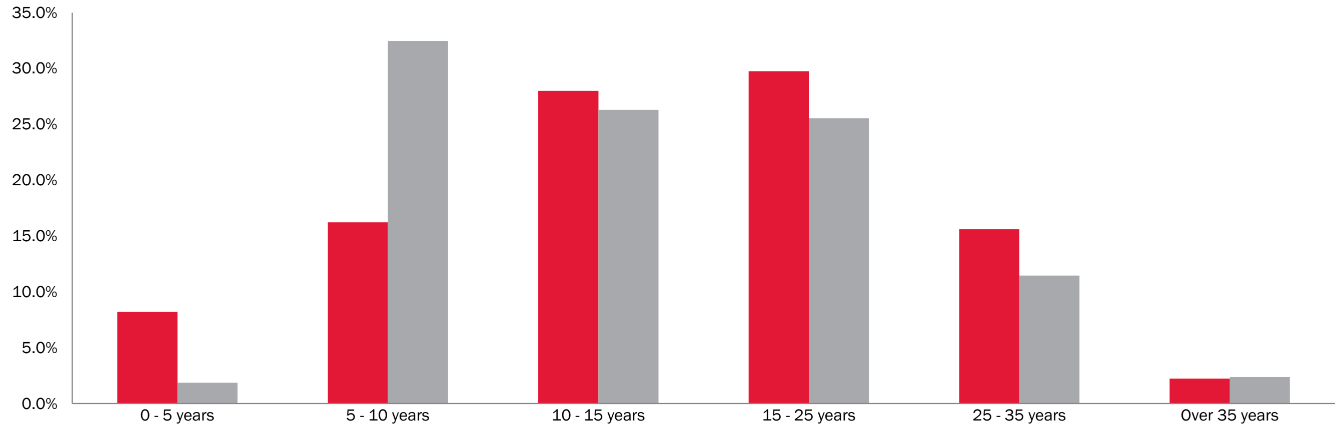
Source: rlam. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio.

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, offset by an underweight exposure to AAA rated securities. New issue purchases increased the weighting in lower rated bonds over the quarter.	BBB was the best performing sector; AAA rated bonds gave a modest outperformance versus gilts.	The credit rating profile of the portfolio was beneficial to overall fund performance.

RLPPC UK OVER 5 YEAR CORPORATE BOND FUND

Quarter 4 2013

Maturity profile



	0 - 5 years	5 - 10 years	10 - 15 years	15 - 25 years	25 - 35 years	Over 35 years
PPLCP	8.2%	16.2%	28.0%	29.8%	15.6%	2.2%
Benchmark	1.9%	32.5%	26.3%	25.5%	11.5%	2.4%

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 marginally above benchmark throughout most of the quarter.	Gilt yields rose by more than we expected, ending the year above 3.0% for ten year maturities.	Duration was not a material 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.	Excess returns were similar for maturities greater than five years.	Yield curve positioning was not a material factor in relative performance.

Ten largest bond holdings

	Rating	Weighting (%)
Abbey National Treasury 5.75% 02/03/2026	AAA	1.6
Annington Finance 0% 07/12/2022	AAA	1.5
Finance For Residence Soc Housing 8.369% 05/10/2058	AA	1.4
Equity Release Funding 5.88% 26/05/2032	A	1.3
Lloyds Bank Plc 6% 08/02/2029	AAA	1.3
Circle Anglia 7.25% 12/11/2038	A	1.1
Barclays Bank 10% 21/05/2021	BBB	1.0
GE Capital 6.25% 05/05/2038	AA+	1.0
Nationwide Building Society 5.625% 28/01/2026	AAA	1.0
Annes Gate Property 5.661% 30/06/2031	bbb (rl)	0.9
Total		**12.1**

Source: rlam. Figures in the table above exclude derivatives where held. Lower case indicates RLAM internal rating.

RLPPC UK OVER 5 YEAR CORPORATE BOND FUND

Quarter 4 2013

Fund activity

- New issue activity picked up in the quarter, as issuers were attracted by low government bond yields and credit spread premiums at six year lows. New issues purchased during the quarter covered attractively priced deals across several sectors.
- Within asset backed sectors, we participated in a long dated A rated bond from **Heathrow Funding**, priced to yield 1.17% above the relevant gilt yield. Heathrow plans to use the proceeds to repay short-term debt and to support further investment programmes, including the planned opening in 2014 of the new Terminal 2.The bonds are secured against the assets of the issuer. The fund also participated in a new 15 year bond rated BBB from **Health Care REIT Inc**, a US REIT specialising in care homes and medical facilities. The bond had the benefit of US REIT covenants i.e. restrictions on the amount of leverage, asset encumbrance and income cover. The bonds were issued at 1.78% above the benchmark gilt.
- The fund has had a long standing commitment to the social housing sector; this reflects our view that industry regulation, government support through the benefit system / legacy grants and the ultimate security of housing assets makes the sector attractive for long term bond investors. During the quarter we added to the position in **Peabody**, which owns and manages more than 20,000 homes across London. This housing association only operates in London and manages a range of tenures: social housing, leasehold, shared ownership, supported housing, and key-worker accommodation. The £350m bond is secured against a portfolio of property and is rated A2 by Moody's; it was priced at 105 bps over the yield of the benchmark gilt.
- Another notable new issue purchase in the quarter was from **Prudential plc**. This £700m subordinated bond is due to mature in 2043 and was priced at 2.08% over the yield of the benchmark gilt. The credit rating is split, with Moody's and S&P awarding a slightly higher rating than Fitch (A3/A- compared with BBB+). We felt that the strong position of the Prudential in its key markets and the yield compensation offset the subordination of the bond structure.
- Activity in the secondary market was relatively subdued with purchases focused around the structured and secured sectors.
- Sales undertaken over the quarter reflected switching opportunities (e.g. **Tesco**), raising cash for new issues (**GDF Suez**) or reducing exposure following strong performance over the quarter (**Porterbrook Rail**).
- We accepted a tender for tier 1 **Yorkshire Building Society** bonds at a price of 150. First purchased in 2011 at prices below 115, these securities had been originally issued under the terms of Yorkshire's takeover of the Chelsea Building Society.

Key views within the portfolio

- A significant underweight in supranational bonds as we expect credit bonds to outperform.
- 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

- The US Federal Reserve (Fed) announced a $10 billion tapering of its monthly quantitative easing bond purchase programme.
- The European Central Bank (ECB) unexpectedly cut interest rates from 0.50% to a record low of 0.25% in November.
- UK growth forecasts continued to move higher; the UK's Office for Budget Responsibility upgraded their growth forecast to 1.4% in 2013 and 2.4% in 2014.
- China announced wide ranging structural reforms aimed at overhauling its economy over the next decade.

Growth

- Investor sentiment stayed reasonably positive over the quarter, in response to a degree of rapprochement in US politics, less concern about the prospect of Fed policy tightening, better economic data trends and no significant deterioration in Emerging Market prospects.
- UK gross domestic product (GDP) rose by 0.8% in the third quarter, with the main business survey indicators suggesting that momentum continued into the fourth quarter. Growth in output has been fairly broadly based across sectors, with construction making a notable positive contribution. Consumer confidence has recovered, while housing market transactions have risen above 90,000 per month, having averaged around 75,000 per month from 2010 to 2012. Mortgage approvals have also increased, although this has yet to have a material impact on secured lending growth. House prices are rising at close to 1% per month, with the national average concealing significant variation across regions. The headline rate of unemployment has fallen to 7.4%.
- In the US, October's government shutdown had a temporary effect on activity early in the quarter, although subsequent data has been consistent with a general improvement. Consumer confidence rebounded from a sharp fall in October, while business surveys remained strong. Labour market conditions continued to improve although, at 7.0%, the unemployment rate remains above its longer-run normal level, with rates of underemployment and long-term unemployment still high. In December, the Fed signalled its intention to taper quantitative easing purchases, but intends to maintain the current target range for the Fed funds rate "well past the time that the unemployment rate declines below 6.5%".
- Growth in the eurozone remained weak, with GDP estimated to have risen by 0.1% in the third quarter, reflecting slow growth in Germany and France rather than in peripheral countries. Prospects for the fourth quarter remain subdued, with little change in the Euro area composite Purchasing Managers' Indices. Consumer Price Index (CPI) inflation has fallen below 1%, with lower commodity and food prices and Euro appreciation contributing to the decline. Economic slack persists and is concentrated in the peripheral economies, where unit labour costs have been flat, compared to growth of a little over 2% per year in the core. Reflecting the subdued outlook for inflation, the ECB reduced its main refinancing rate by 25 basis points to 0.25% at its November meeting.
- In Asia, Japanese GDP growth slowed to 0.3% in quarter three and there is some concern that the pick-up in activity seen in 2013 may not be sufficiently well entrenched to withstand the increase in VAT scheduled for April 2014. In China, GDP growth in the year to quarter three rose by 7.8%, with the main business surveys suggesting some pick-up in activity since the summer. Demographic change is now helping to lower China's medium term potential growth rate, as the supply of migrant labour declines and the country loses much of its low cost advantages. During the quarter, a detailed roadmap for structural reform was unveiled, following the Central Committee's Third Plenary Meeting.

Inflation

- UK CPI inflation was 2.1% in November, reflecting a smaller than expected contribution from university tuition fees. Towards the end of the quarter, the government announced its intention to remove around £50 of policy costs from annual household energy bills. Assuming all of the reduction is passed through by the utility companies, this would reduce CPI inflation by 0.15%. Some survey based measures of inflation expectations had risen during the quarter. However, there has been no sign that this has fed into larger wage increases.

Interest rates

- With the macroeconomic backdrop still fragile, monetary policy from the main central banks remained supportive over the quarter.
- The ECB reduced its main refinancing rate to a record low of 0.25% and signalled its intention to keep rates low. The Fed subsequently signalled a tapering of its monthly quantitative easing programme. However, it reiterated its commitment to keeping interest rates at their current level for some time.
- In the UK, the Monetary Policy Committee (MPC) continued to adhere to its forward guidance, which implied that it did not intend to increase the bank rate until the unemployment rate had fallen to at least 7%. The MPC did, however, bring forward the date at which it expected the 7% threshold to be reached, to 2015.

Currencies

- Trade weighted sterling continued to rise over the quarter, as the improvement in UK economic data continued to boost sentiment.

BOND MARKET REVIEW

Investment grade: financial & corporate bonds

Key points

- Sterling investment grade credit bonds returned -0.02% over the quarter. While returns across sectors were mixed, all posted higher returns than gilts, with the best performing areas being insurance and bank bonds, particularly subordinated debt.
- Supranational and covered bonds underperformed the wider sterling credit market.
- All sectors saw a narrowing of credit spreads; the average credit spread tightened from 1.38% to 1.18%.

Credit spreads

- Sterling credit bonds outperformed UK government bonds by 1.33%.
- Credit spreads narrowed consistently through the quarter, with the only period of relative weakness being recorded in mid-November, due to issuance-led weakness. The continued tightening of credit spreads reflected a general improvement in risk assets.
- All sectors saw a narrowing of credit spreads, led by subordinated financials; supranational and covered bonds were the laggards.
- At the end of the period, the average credit spread was 1.18% above government bond yields, 0.20% below the spread level prevailing at the end of September 2013 and 0.63% lower over the year.

Financial sectors

- Financial bonds continued to outperform non-financial sectors. Bank and insurance sectors recorded positive absolute returns over the quarter and maintained their positions as being by far the strongest performing sectors over the year. Insurance bonds returned 2.26% over the quarter and 7.57% over 2013 as a whole, while subordinated financial debt gave the highest returns, with tier 1 bonds returning 2.78% over the quarter and an impressive 11.18% for the year.
- Senior unsecured and senior secured (covered) bonds lagged the overall credit market, although credit spreads narrowed in both cases over the quarter; returns were -0.14% and -1.52%, respectively. Covered bonds fared poorly over 2013, returning -3.36%, driven by their longer duration and investor orientation towards more junior debt within financials.

Non-financial sectors

- Most sectors gave a negative return over the quarter, although credit spreads narrowed in all sectors.
- Telecoms and utilities outperformed, with spreads narrowing by 0.33% and 0.14% respectively. Consumer orientated bonds generally lagged, reflecting their already relatively low credit spreads. Supranational bonds continued to underperform over the quarter; the sector’s returns for the year were the lowest for over 15 years at -1.77%.
- Asset backed securities (ABS) underperformed the overall sterling credit market, with spreads narrowing by 0.08%. However, outside of the financial sectors, ABS was the strongest performing sector over 2013, returning 1.31%.
- Peripheral corporate bonds performed strongly, driven by a continued recovery in government markets (e.g. Italy and Spain); Spain’s credit rating outlook was changed from negative to stable. Despite strong performance, peripheral corporate bonds continued to trade wider than core European names by around 0.7%.

Issuance, ratings and maturities

- Issuance increased in the latter part of the period but liquidity conditions remained challenging as demand remained significant, particularly for longer dated securities. With over £11 billion of new bonds brought to market in quarter four, issuance was notably higher than in the previous quarter. For the year as a whole, supply was dominated by non-financial bonds, although quarter four saw a marked pick-up in financial issuance, with several new senior banking and insurance bonds.
- Lower rated bonds again outperformed, reflecting the on-going search for yield; BBB rated bonds gave a return of 0.88%, whilst all other sectors gave negative returns.
- The spreads of lower rated bonds narrowed the most; BBB rated bond spreads fell by 0.45%, whilst A and AA rated bond spreads declined by 0.13% and 0.09% respectively.
- By maturity, there was little material divergence in excess return. Short dated bonds gave a positive return, reflecting their low duration.

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.
- We believe that investment grade sterling credit bonds will deliver moderate positive returns in 2014. While such an outcome will not match the 8% p.a. average return of the past five years, we expect it to exceed the rate of inflation.
- We expect that investment grade sterling credit bonds will outperform UK government securities by at least 1.5% p.a. over the next three years.

BOND MARKET REVIEW

Conventional government bonds

Key points

- Conventional gilts returned -1.35% over the quarter.
- The Bank of England Monetary Policy Committee (MPC) left policy and quantitative easing unchanged at 0.5% and £375 billion, respectively, with no members calling for further stimulus. Forward guidance, based on the unemployment threshold of 7%, suggested that interest rates would remain at their current level at least until late 2015; this was a change of stance as the MPC had previously stated that rates would remain on hold till late 2016.
- UK consumer price index (CPI) inflation fell to 2.1% in November, while third quarter gross domestic product (GDP) rose by 0.8%, resulting in 1.9% year-on-year growth.
- Issuance was concentrated in 5 to 10 year maturities, with one 2068 conventional gilt syndication; the Debt Management Office (DMO) announced that there will be an index linked 2068 syndication in January.
- Medium dated gilts underperformed long and short dated gilts on a risk adjusted basis as data continued to improve and the market was surprised by the US Federal Reserve (Fed) announcement in December to taper its asset purchase program.
- Low European inflation and an interest rate cut by the European Central Bank (ECB) led to an outperformance by core European government bonds versus gilts. In addition, peripheral bond spreads tightened into year end.

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 over the quarter. The re-rating of interest rate expectations, and the unwinding of positions to benefit from low interest rates, resulted in the 5 to 10 year area performing poorly.
- Issuance in conventional gilts was concentrated between 5 and 10 year maturities; index linked gilt issuance was more skewed towards longer dated bonds.
- Conventional gilt issuance for the upcoming quarter will be spread between 5, 10, 30 and 50 year maturities. Index linked gilt issuance will be light, with a 2068 index linked syndication scheduled for January.
- Over the quarter, conventional gilt yields rose 0.30% at short maturities, 0.30% at medium maturities and 0.10% at long maturities.

Variation of return across the UK market

- Overall, the UK government bond market gave a total return of -1.35% over the quarter, with short dated gilts returning -0.31%, medium dated gilts -1.89%, and long dated gilts -1.79%.

Overseas fixed interest markets

- Short and medium dated gilts performed broadly in line with US government bonds, reflecting the better domestic data, but underperformed Europe due to low inflation levels and an ECB rate cut. Long dated gilts outperformed their overseas counterparts as large index changes and strong liability driven investment (LDI) demand from the UK pension fund community was prevalent into year end.
- 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 December by announcing the start of tapering of their asset purchase programme, and Janet Yellen was nominated as the new Chair of the Board of Governors to succeed Ben Bernanke when his eight year tenure ends on January 31.

Outlook

- Economic news continues to suggest strong momentum in the UK, although the level of output is still well below its long term trend.
- Headline inflation is low and underlying inflationary pressures appear contained, in particular thanks to slow wage growth and stronger sterling.
- We expect interest rates to remain on hold during 2014, although the Bank of England may use macro prudential tools to cool momentum in the housing market. The peak in base rates is likely to be much lower than usual during the current economic cycle, resulting in a flatter yield curve.
- Our central case is for gilt yields to rise further over the next twelve months, although we expect some volatility around this trend.
- Our 31 December 2014 forecasts for 5, 10 and 30 year conventional gilt yields are 2.2%, 3.2% and 3.9% respectively; current yields are 1.9%, 3.0% and 3.7% respectively.

BOND MARKET REVIEW

Index linked bonds

Key points

- Index linked gilts returned -0.89% over the quarter.
- Inflation, as measured by the UK consumer price index (CPI), fell to 2.1% in November, its lowest rate of increase in four years.
- Real yields generally rose throughout the quarter. The only divergence from this was a small rally in October after the US failed to find a long lasting agreement to its fiscal differences, raising medium term concerns and supporting bond markets. The 5 to 10 year sector saw the largest moves with yields rising by over 0.35% on the quarter.
- A combination of expectations of earlier than expected rate hikes in the UK and strong pension fund related demand for longer dated assets led to a flattening of the real yield curve.
- Oil prices were lower over the quarter and, combined with a strong Pound, led to forecasters lowering their inflation forecasts for the early part of 2014.
- Breakeven inflation rates, particularly for shorter dated maturities, fell at the beginning of the quarter as inflation surprised to the downside but later recovered as the market brought forward its expectations on the timing of the first UK base rate hike.

Real yield and breakeven (implied) inflation curve moves

- Real yields fell at the beginning of the quarter after the US failed to find a long lasting agreement to its fiscal differences, raising medium term concerns and supporting bond markets. However, data continued to show an improving outlook in the UK, and the November inflation report indicated a greater probability of base rates being raised earlier than forecast, leading to real yields rising over the remainder of the quarter.
- Breakeven inflation rates, particularly in the 5 to 10 year sector, fell sharply at the beginning of the quarter as inflation undershot forecasts. The November inflation report and strong economic and survey data led a number of economists to bring forward their expectations on the timing of a base rate rise, with some looking for a rise as early as the final quarter of 2014. This led to breakeven inflation rates recovering such that, on the quarter, 10 year breakeven rates were unchanged, while longer dated breakeven inflation rates were 0.1% higher.

Variation of return across the UK market

- The real yield differential between 10 and 30 year bonds ended the quarter around 0.15% lower, leaving the curve at its flattest for the year and 1.00% flatter than levels seen in March. This was the result of strong demand from pension funds for longer dated assets and selling of shorter dated assets by overseas investors.
- The FTSE Index Linked Gilts All Stocks Index gave a return of -0.89% over the quarter, leaving the twelve month return at 0.54%. Index linked gilts posted negative returns across all maturities, with the 10 year sector returning the worst at around -1.70%, whilst longer dated bonds returned -0.60%.

Overseas and credit index linked market

- Overseas index linked government bonds outperformed in the 10 year sector, with Swedish bonds performing particularly well. At the longer end of the market, the UK outperformed; the real yield differential between long dated UK and US bonds rose to 1.60% over the quarter.
- Sterling non-government index linked bonds outperformed index linked gilts by around 0.1% over the quarter.

Outlook

- We believe that long term real interest rates of zero are too low and do not reflect long term economic fundamentals.
- Pension fund demand remains strong for longer dated real yield securities. With supply concentrated at the longer end of the market, including a syndication of the 2068 issue in January, we would anticipate underperformance by ultra-long dated index linked bonds early in the first quarter of 2014.
- Long breakeven inflation rates of above 3.5% are now marginally above our 2014 year-end target; we expect them to fall as retail price index (RPI) inflation falls in the first quarter of 2014.
- 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 2014 are -0.1% and 0.5% respectively, significantly higher than at the end of 2013.

BOND MARKET REVIEW

Overseas government bonds

Key points

- Stronger survey data in Japan was accompanied by confirmation that consumption tax will increase.
- Janet Yellen was nominated to succeed Ben Bernanke as Chair of the Board of Governors of the US Federal Reserve (Fed).
- US politicians reached a short term agreement on the federal budget and agreed to extend the debt ceiling, though failure to find a long lasting agreement raised medium term concerns and supported bond markets in October.
- The Fed decided to begin tapering its quantitative easing programme at the December meeting as US gross domestic product (GDP) growth and employment surveys generally remained robust.
- Weak eurozone inflation prompted the European Central Bank (ECB) to reduce its benchmark rate from 0.50% to a record low of 0.25% in November.
- The Swedish central bank cut its benchmark rate from 1.00% to 0.75%, in line with market expectations.
- Irish authorities announced their intention to exit their bailout programme.

Yield curve moves over the quarter

- Yields rose over the quarter as the market brought forward its expectations of medium term base rate hikes following the Fed's decision to taper its quantitative easing bond purchase programme by $10 billion per month.
- Failure by US politicians to find a long lasting agreement to their fiscal differences in October, when the debt ceiling was extended and a short term budget agreement was reached, raised medium term concerns and temporarily supported bond markets.
- The yield of 10 year US government bonds rose from as low as 2.5% in October to end the quarter at a high for the year of 3.0%.
- Following weak eurozone inflation data, the surprise decision by the ECB to cut base rates to a record low of 0.25% supported European government bonds relative to other markets.
- At the end of the quarter, 10 year government bond yields in the US, Germany, Japan and the UK were 3.0%, 2.0%, 0.7% and 3.0% respectively.
- Implied inflation rates posted small rises over the quarter as global economic activity remained firm.
- At the end of the quarter, 10 year real yields in the US, core Europe and the UK were 0.8%, 0.4% and -0.2%. Accompanying breakeven inflation rates were 2.2%, 1.6% and 3.2%.
- Yield curves flattened between medium and longer dated maturities as base rate expectations were revised upwards.

Currency markets

- Over the quarter, sterling strengthened against the basket of currencies in the indices.
- The largest moves were against the Japanese Yen and commodity based currencies.

Outlook

- We expect that global economic growth will be subdued over the near term although, in our view, the risk of significant double dip recession has reduced.
- 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

- Global high yield bonds (BofA Merrill Lynch Global High Yield Index, 100% hedged to sterling) returned 3.5% over the quarter. Returns were quite varied over this period (October 2.5%, November 0.4%, December 0.6%) and achieved 7.3% for 2013 as a whole.
- The best performing sectors were insurance (4.7%) and utilities (4.6%). Consumer cyclicals (2.9%) and energy (2.9%) were relative laggards.
- Global new issuance in the quarter was over $101 billion but down 18% on the same period last year. This was due to a low level of issuance across all three months. Issuance over the year set a new record high at over $463 billion, 8% higher than the previous record highest year of 2012. Issuance in the US and Europe accounted for 58% and 20% of this, respectively, with issuance in Emerging Markets and Other Developed Markets accounting for the remainder.
- The yield on the index ended the quarter 0.6% lower at 5.7%, and the average high yield credit spread at 4.2% above government bond yields, having tightened 0.9% from the level prevailing at the end of September. This spread is well above the all-time low of 2.4%, set in May 2007.

Regions

- The US and Canada region returned 3.5% for the quarter and 7.3% for 2013. Most of the fourth quarter's returns were produced in October. November moved with much less certainty, while December was a month of strong credit compression in the face of rising underlying government yields.
- Europe returned 4.0% for the quarter and was the outperforming region, as it was in both quarters two and three. For 2013, the region returned 10.5%. Bonds in this area outperformed due to the greatest amount of spread tightening, helped by the most attractive relative valuations to start the quarter and the year.
- Emerging Markets was again the weakest performing region, returning 2.7% in the quarter and 1.7% for 2013. This region produced 2.6% returns in October, with the positive returns in December effectively offsetting the weak performance in November.

Monthly performance

- In October, the global high yield market produced its best monthly return since February 2012, with returns consistently positive throughout the month. The month began with weaker than expected employment data in the US, which promoted the perception of a delay in the tapering of US monetary policy. This supportive tone in the market was further reinforced by the resolution of the US government shutdown and a suspension of the debt ceiling. The divergence of returns by region was quite small. In spite of a tick up in defaults in the Emerging Markets, it was this region which was the geographic outperformer due to its poor year to date performance and its heightened sensitivity to US government yields levels.
- After the impressive returns witnessed over the previous two months, November was a more restrained period for global high yield bonds, as the market moved with much less conviction. The month began softly due to the movement in underlying government yields. Stronger than expected US payroll data was released and US 10 year government yield added 0.15% in a single day, its weakest one day performance in yield terms since July. While this sell-off in underlying government bonds continued throughout the month, it was shortly after this point that credit spreads began to compress and the impact of the markets substantial 'carry' took effect.
- December saw a continuation of the trends that had been witnessed in the market since the end of the summer, after the impact of the interest rate led sell-off. These were the trends of both positive returns and spread compression. Despite higher underlying government yields and the decision to taper monetary policy by the US Federal Reserve (Fed), the commitment to maintain accommodative policy supported risk assets.

Ratings & maturities

- For the quarter, lower rated bonds broadly generally outperformed. BB, B and CCC and lower rated bonds returned 3.3%, 3.5% and 4.1% respectively for the quarter. Yields at the end of the quarter now stand at 4.6%, 6.0% and 9.0%, respectively.
- Returns for the quarter were better the longer the maturity of the asset as spread compression offset the higher government yields. Returns were 2.6% for 0 to 3 years, 3.2% for 3 to 5 years, 3.7% for 5 to 7 years, 3.8% for 7 to 10 years and 4.2% for over 10 years.

Outlook

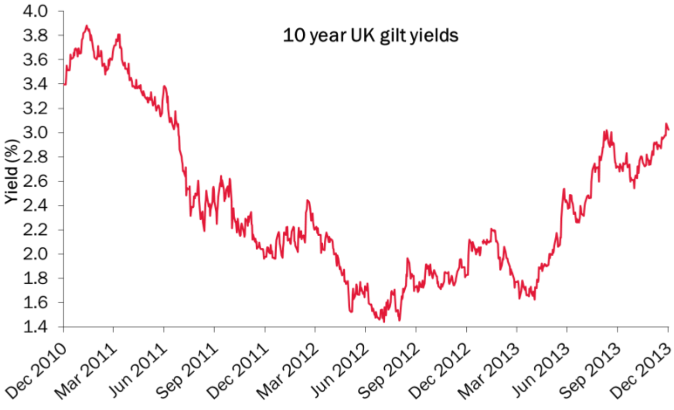
- We expect the performance of the US recovery to underpin the growth in the global economy in the medium term, despite more challenging economic conditions within the Eurozone.
- We expect bouts of market volatility due to the withdrawal of supportive monetary policy by the US Fed. As such we believe bonds with near term catalysts, which mitigate market risk, are an important attribute underlying investment performance over 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 on a relative basis.
- 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, a robust level of new issuance is expected for 2014.

SPECIAL TOPIC

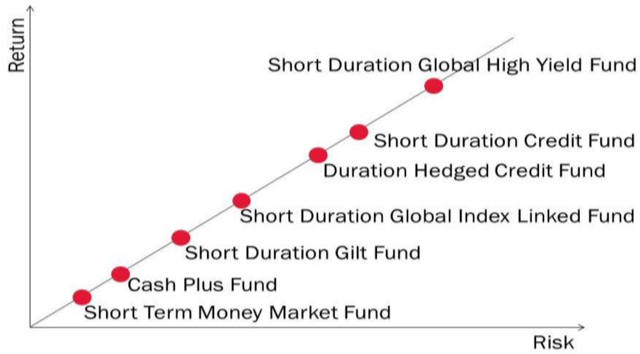
Strategies and products for a rising and volatile rate environment

Since the first real mention, in May 2013, of a possible reduction by the US Federal Reserve (Fed) of its quantitative easing (QE) program of asset purchases, and even without any actual change in the level of central bank rates, government bond yields in the US and other markets (including the UK) have risen to reflect the markets' expectations in relation to the future path of central bank rates. In December the Fed announced the tapering of QE – a first step in the long road towards unburdening markets of the weight of QE.

In the UK, despite increasingly positive survey and economic data, there has been no change to the Bank of England's (BoE) Asset Purchase Facility target, which remains at £375 billion. However, the BoE has acknowledged that the speed at which the unemployment rate has begun to fall would mean that the 7.0% threshold, as set out in its own forward guidance, is likely to be reached sooner than originally anticipated (in 2015 rather than 2016). Given how much has been said of the need to keep rates lower for longer in the UK, the unemployment threshold may need to be reviewed.



Source: RLAM



Source: RLAM. Illustrative

We believe that rates will remain at their current 0.5% level over 2014. Despite this, we would expect gilt yields to continue to reflect expectations of the eventual path of rates as well as the broader economic picture. Depending on the extent of rises in gilt yields, returns from gilts are expected to range between a very small positive to moderately negative; for 10 year maturity gilts, returns over 2014 would be zero were the yield to be 3.35% at the end of the year - any higher and the total return will be negative. We would expect the yield on 10 year gilts to rise moderately from its current level to above 3.25% and approaching 3.50% by the end of 2014. However, economic and political risks exist that mean that higher gilt yields are not assured: a long term solution to the US debt limit has not been reached and underlying problems remain unsolved in the Euro area. In addition, China's medium term potential growth rate is under pressure which may presage problems in the banking sector.

Against this background of uncertainty but expecting a gradual move higher in government bond yields RLAM has recently launched a suite of **short duration bond funds**, covering **conventional gilts**, **global index linked government bonds** and **credit**. These actively managed funds will invest predominantly in their core asset type but have flexibility to invest outside of their respective benchmark universes. The funds complement the existing portfolio of strongly performing low duration funds: **Short Duration Global High Yield** fund and the **Duration Hedged Credit** fund, as well as the lower risk **Money Market** and **Cash Plus** funds.

Even in a rising or volatile rate environment, there still exist opportunities to add value in fixed income through exploitation of medium term strategic views and short term relative value opportunities in bond markets. With this in mind, RLAM is likely to develop an **absolute return government bond** fund with a focus on the major developed markets that captures our successful approach to government bonds: active management with strong risk budgeting and global awareness. In addition, RLAM will follow up the launch of the absolute return government bond fund with the development and launch of an additional complementary fund that will also be managed within an absolute return framework. This fund will aim to take advantage of the wide range of funds RLAM currently offers as well as investing in further asset classes aimed at alpha generation. This fund is likely to invest across a broad range of fixed income asset classes including loans, global high yield, infrastructure bonds and emerging market debt. We believe that our existing range and our new initiatives will offer the opportunity for positive returns in even adverse environments.

INVESTMENT OUTLOOK

Key points

- Our central case assumes 2.7% 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 2015 at the earliest and remain low relative to inflation, which is expected to remain close to target over the next 12 months.
- We remain positive on sterling credit bonds relative to conventional and index linked government bonds.

Global economic growth prospects

- Since September, economic news in most major economies has been broadly in line with our existing expectations, and we have kept our base case GDP forecasts largely unaltered, aside from an upgrade to the UK. Our central assumption remains that the acute nature of the financial crisis, and in particular the large rise in debt levels which preceded it, means that the process of normalisation will be lengthy and subject to volatility. Our base case continues to assume a reacceleration of global activity during 2014, thanks to a pick-up in the US and eurozone economies.
- We expect the pace of UK economic growth to rise in 2014 to 2.7%, close to its long term trend. GDP rose by 0.8% in the third quarter, and the main business survey indicators suggest that momentum has continued to be positive. For the recovery to be sustained, real incomes will have to improve, while business investment will also need to respond to the initial boost in demand. There are signs that this latter process is in train, given the rise in business confidence. We expect growth will be driven mainly by domestic demand, rather than net trade, where the gains from devaluation have been rather disappointing.
- During 2014, we expect a smaller fiscal drag in the US so, assuming the underlying private sector momentum remains at its 2013 level, real GDP growth should pick up to 2.5 to 3.0%. 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 1.0%, while in China, growth will average 7.5%.
- The impact of the eurozone crisis on market sentiment has waned over the past 12 to 18 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 this is not part of our base case.

Inflation and growth – how will they impact interest rates?

- Inflation, as measured by the UK consumer price index (CPI), fell to 2.1% in November, below our September base case, reflecting a smaller-than-anticipated contribution from university tuition fees. We have reduced our expectation for inflation in 2014, in part due to the likely impact of the recent rise in sterling. Despite a lengthy period of above target CPI, there are few signs of a classic wage inflation spiral taking hold. It does seem clear that there is significant spare capacity today in the UK labour market, where the level of unemployment is still higher than its pre-crisis level.
- The Monetary Policy Committee has 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 policy rates to remain on hold in the US and UK during 2014, and any future rise in rates to be modest, thanks to ongoing fiscal restraint and banking and household sector sensitivity to tighter monetary conditions.

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 low real returns. We do expect yields to move higher from current levels. However, 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 our growth and inflation scenario. 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 1.5% p.a. over the next three years.

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.

RLAM

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.

Distribution team changes

We welcome Tracy Fennell to RLAM as Head of Marketing. She joins us from F&C where she was Head of Marketing & Communication. Previously she held UK and international marketing roles at SWIP, AXA Investment Management and Newton. Tracy will focus on running RLAM's communications, promotional and branding activities.

Susan Spiller, RLAM's previous Head of Marketing, has a new role as Head of Proposition, reflecting RLAM's continued focus on product development. Susan's role will focus on strategy, new product development, product management and product support.

We also welcome Louise Merritt to RLAM as a Product Manager on the Proposition Team where she will be working closely with Matt Baker and Arnab Ganguly on both new product development and management of our existing product range. Louise has previously worked in similar roles at F&C and Aviva Investors.

RLAM

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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.

DTS – Duration times spread – An expression of the portfolio's sensitivity to changes in yield spreads (the difference between the yields of credit bonds and government bonds) based on proportional spread movements. DTS is an appropriate measure for credit portfolios in particular, and for managers with particular skill in sector and stock selection and a focus on these.

Duration – A measure of the sensitivity of the portfolio to small and uniform changes in bond yields across the maturity spectrum. Duration, also referred to as interest rate risk, is expressed in years as a result of the measure's calculation from the weighted average maturity of all of the portfolio's discounted future 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.

GLOSSARY

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

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

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

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

FX – Foreign exchange.

Gearing – The level of debt to equity.

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

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

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

Investment restrictions – Restrictions imposed on the portfolio managers by clients as outlined in the investment management agreement (IMA).

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

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

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

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

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

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

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

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

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

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

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

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

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

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

GLOSSARY

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.

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 – Defined as the standard deviation of the fund's excess return over the benchmark index return, and generally quoted as an annualised figure based on monthly observations. This measure quantifies how closely the portfolio's return pattern follows that of a benchmark index. It is an important concept in risk measurement, and is used as both an ex post (historic) and ex ante (expected) measure. RLAM employs systems that allow us to estimate the ex ante tracking error of a portfolio.

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.

Issued by **rlam** on 31 December 2013. Information correct as at that date unless otherwise stated.

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Portfolio Valuation

As at 31 December 2013

Dorset County Pension Fund

rlam®
royal london asset management

	Holding	Asset Description	Market Price (Bid £)	Book Cost Capital (£)	Market Cap. Value (£)	Accrued Inc. Value (£)	Market Value (£)	Days Accrued	Market Value %
Funds Held									
	110,648,432	RLPPC Over 5 Year Corp Bond Pen Fd	1.71943	121,135,247.30	190,252,232.60	0.00	190,252,232.60	0	100.0
			Funds Held total	**121,135,247.30**	**190,252,232.60**	**0.00**	**190,252,232.60**		**100.0**
			Grand total	**121,135,247.30**	**190,252,232.60**	**0.00**	**190,252,232.60**		**100.0**

Trading Statement

For period 01 October 2013 to 31 December 2013

Dorset County Pension Fund

Acquisitions

Funds Held

Trade Date	Transaction Type	Nominal	Security	Price (£)	Book Cost (£)
03 Oct 2013	Acquisition	162,757.49	RLPPC Over 5 Year Corp Bond Pen Fd	1.74	282,726.04
07 Oct 2013	Acquisition Rebate	80,865.41	RLPPC Over 5 Year Corp Bond Pen Fd	1.74	140,505.27
				Funds Held total	**423,231.31**
				Acquisitions total	**423,231.31**