Insight INVESTMENT

DORSET LIABILITY MATCHING PORTFOLIO

For the period
01 January 2014 to 31 March 2014

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Investment Summary

DORSET LIABILITY MATCHING PORTFOLIO

For the period 01 January 2014 to 31 March 2014

Summary of Performance

Performance summary to 31 March 2014

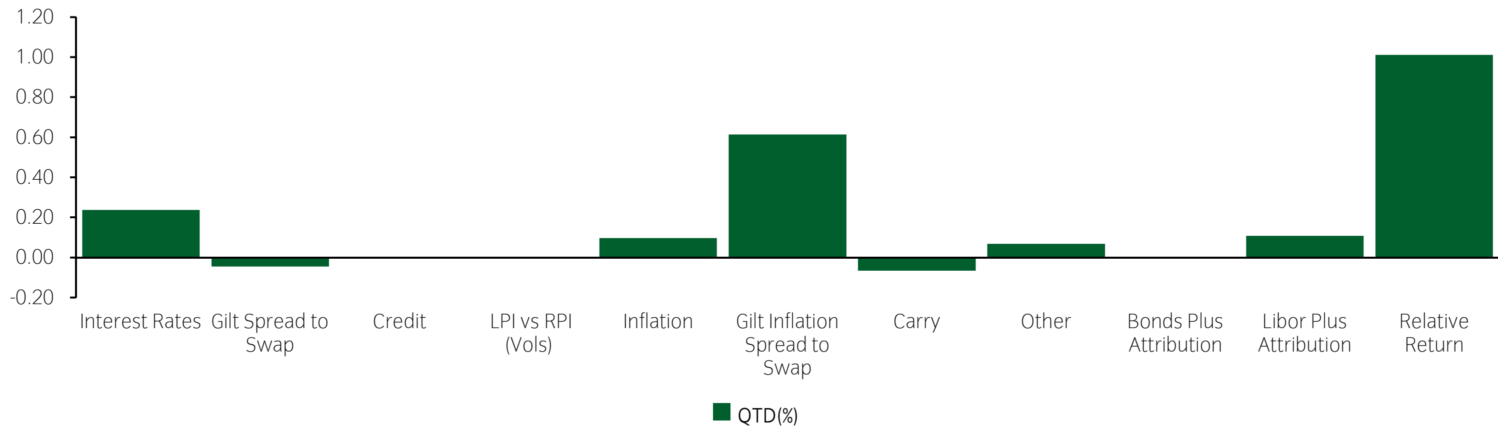
	3 Months (%)	1 Year (%)	Since Inception (%)
Portfolio	3.22	-5.73	23.24
Benchmark	2.18	-8.30	20.33
Relative Return	1.03	2.56	2.91

	3 Months (£)	1 Year (£)	Since Inception (£)
Portfolio	6,067,959	-12,290,401	51,360,659
Benchmark	4,153,247	-17,598,403	44,899,772
Relative Return	1,914,713	5,308,002	6,460,887

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 Attribution

Quarter-to-date relative percentage attribution



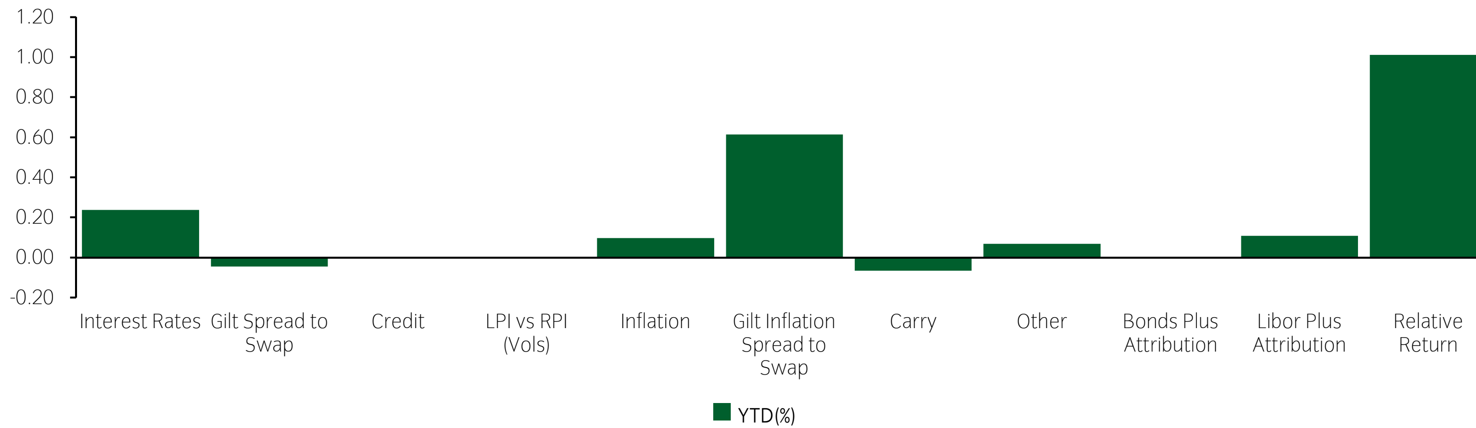
Description	QTD (%)
Interest Rates	0.24
Gilt Spread to Swap	-0.05
Credit	-0.00
LPI vs RPI (Vols)	0.00
Inflation	0.10
Gilt Inflation Spread to Swap	0.61
Carry	-0.07
Other	0.07
Bonds Plus Attribution	0.00
Libor Plus Attribution	0.11
Relative Return	1.01

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



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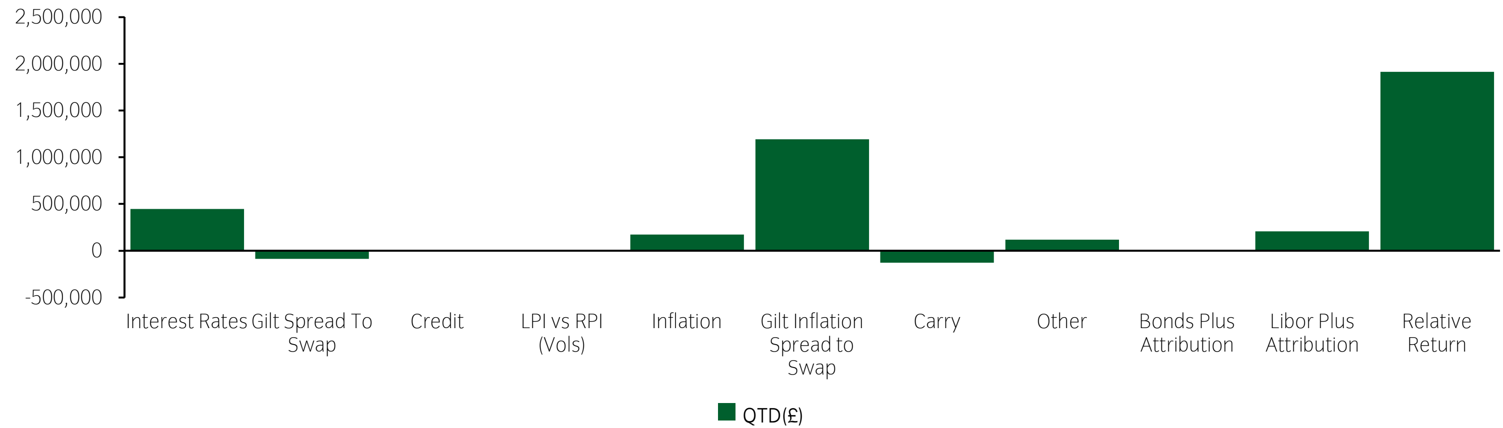
Carry	-0.07
Other	0.07
Bonds Plus Attribution	0.00
Libor Plus Attribution	0.11
Relative Return	1.01

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

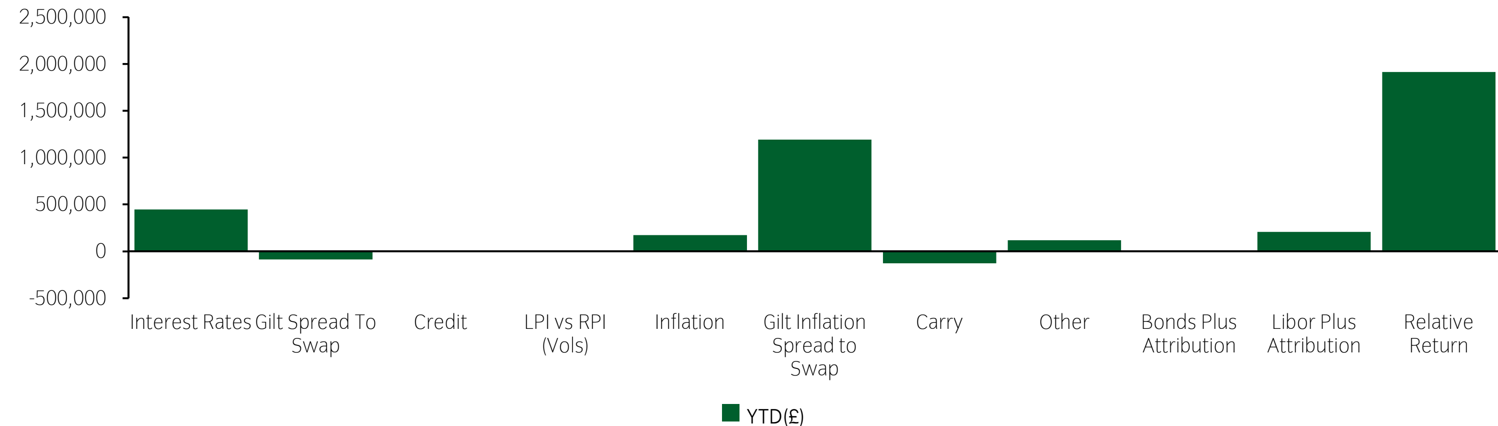


Description	QTD (£)
Interest Rates	445,158.88
Gilt Spread To Swap	-87,097.29
Credit	-5,906.64
LPI vs RPI (Vols)	0.00
Inflation	173,974.70
Gilt Inflation Spread to Swap	1,190,831.98
Carry	-126,222.35
Other	117,041.74
Bonds Plus Attribution	0.00
Libor Plus Attribution	206,931.76
Relative Return	1,914,712.78

All figures are calculated geometrically

LDI Attribution

Year-to-date relative monetary attribution



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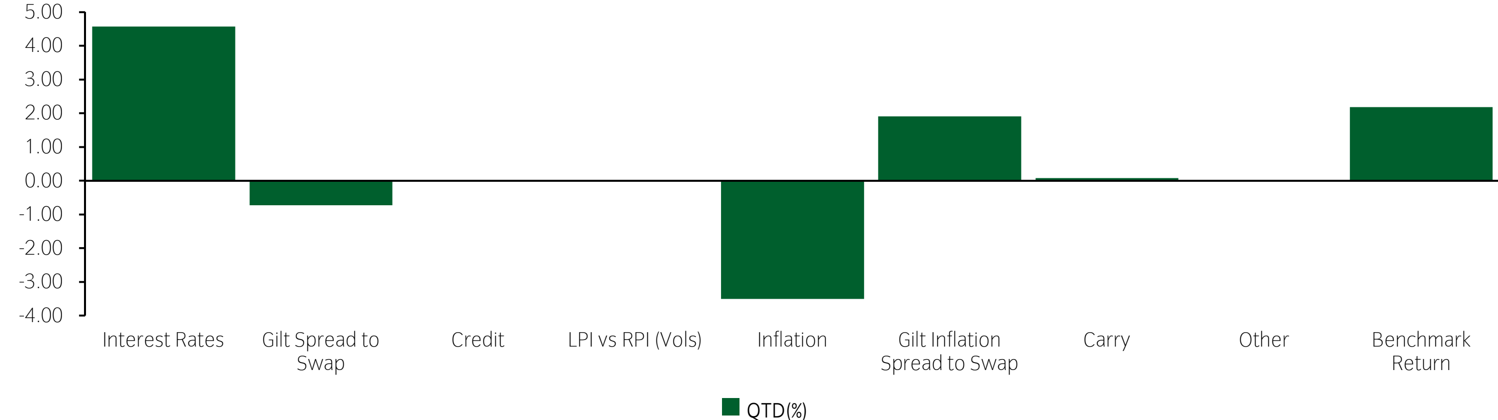
All figures are calculated geometrically

LDI Attribution

Quarter-to-date benchmark percentage attribution



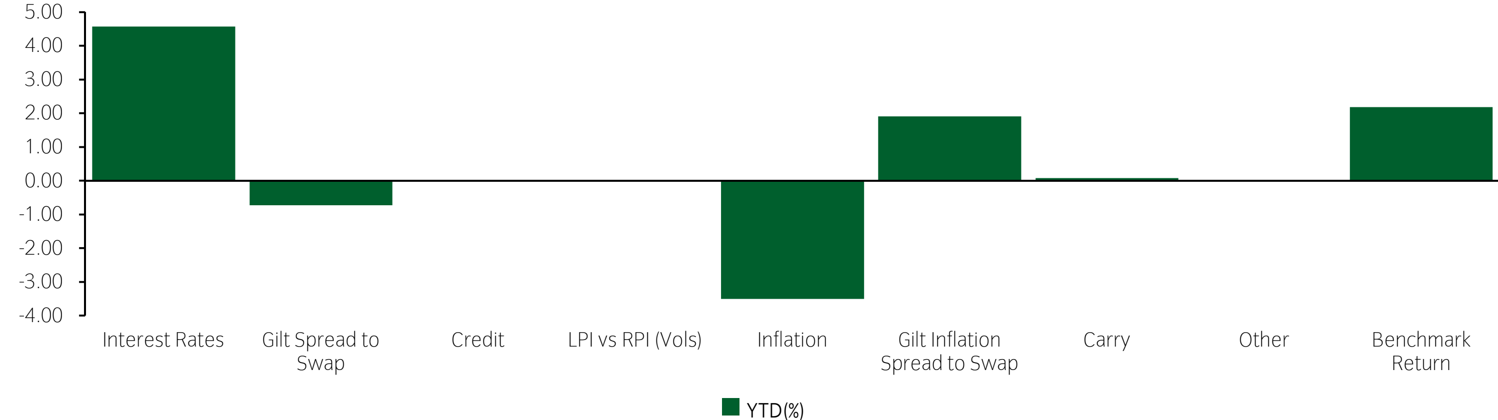
Description	QTD (%)
Interest Rates	4.57
Gilt Spread to Swap	-0.73
Credit	-0.00
LPI vs RPI (Vols)	0.00
Inflation	-3.51
Gilt Inflation Spread to Swap	1.91
Carry	0.08
Other	0.03
Benchmark Return	2.18

Note: The percentage attributes and returns are calculated geometrically.

All figures are calculated geometrically

LDI Attribution

Year-to-date benchmark percentage attribution



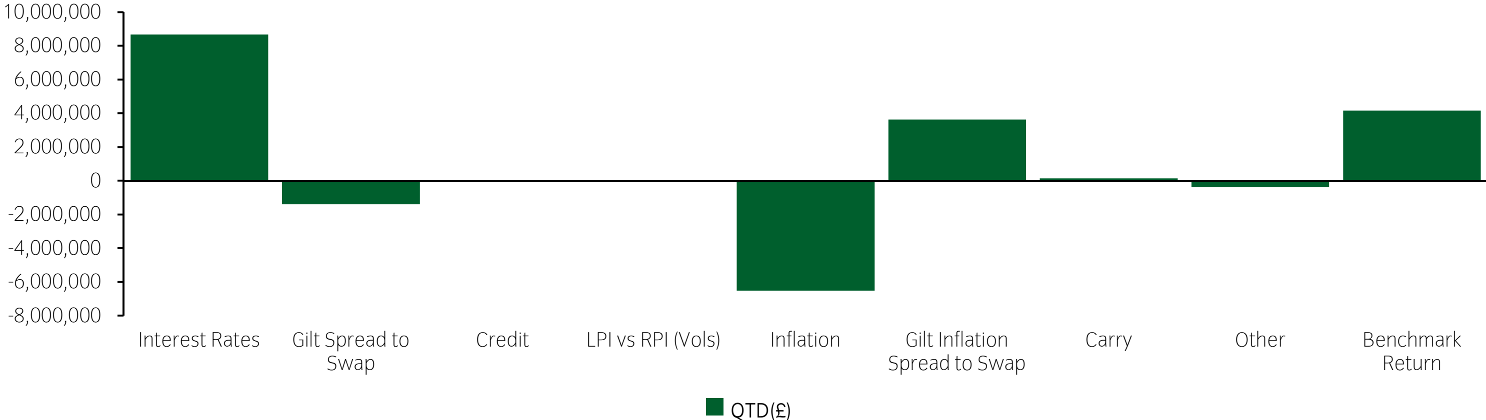
Description	YTD (%)
Interest Rates	4.57
Gilt Spread to Swap	-0.73
Credit	-0.00
LPI vs RPI (Vols)	0.00
Inflation	-3.51
Gilt Inflation Spread to Swap	1.91
Carry	0.08
Other	0.03
Benchmark Return	2.18

All figures are calculated geometrically

Note: The percentage attributes and returns are calculated geometrically.

LDI Attribution

Quarter-to-date benchmark monetary attribution

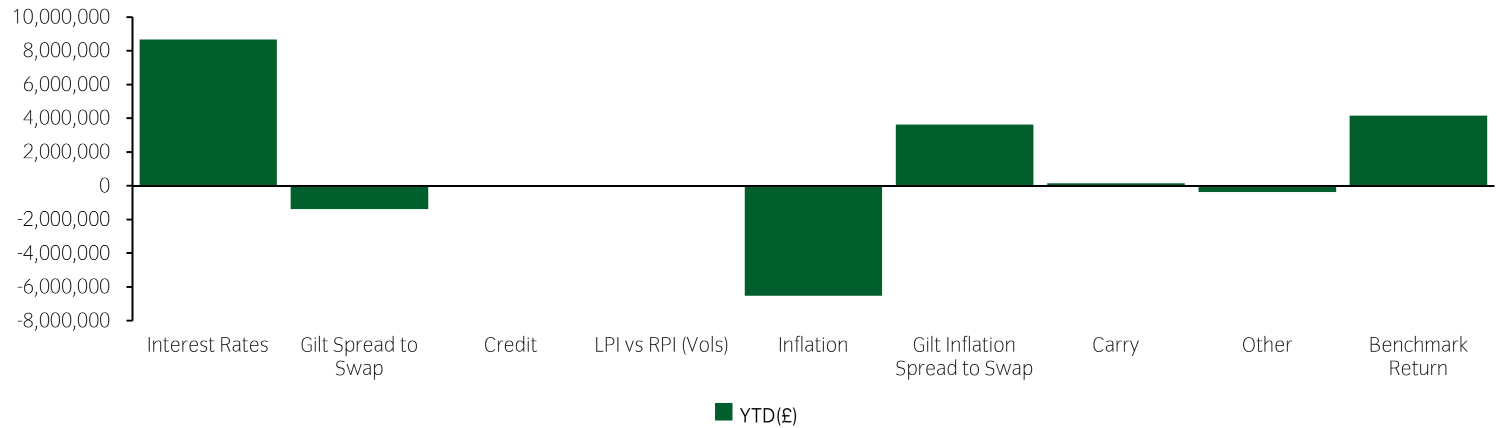


Description	QTD (£)
Interest Rates	8,665,752.84
Gilt Spread to Swap	-1,404,275.55
Credit	-6,481.34
LPI vs RPI (Vols)	0.00
Inflation	-6,519,082.20
Gilt Inflation Spread to Swap	3,635,268.56
Carry	147,853.39
Other	-365,789.06
Benchmark Return	4,153,246.64

All figures are calculated geometrically

LDI Attribution

Year-to-date benchmark monetary attribution



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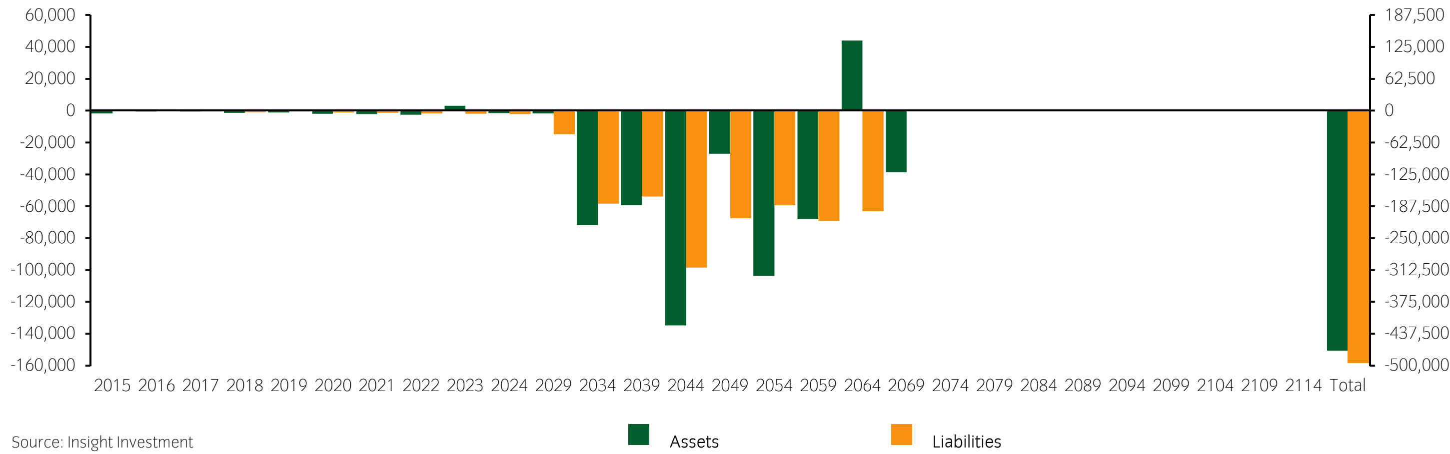
All figures are calculated geometrically

LDI Analysis

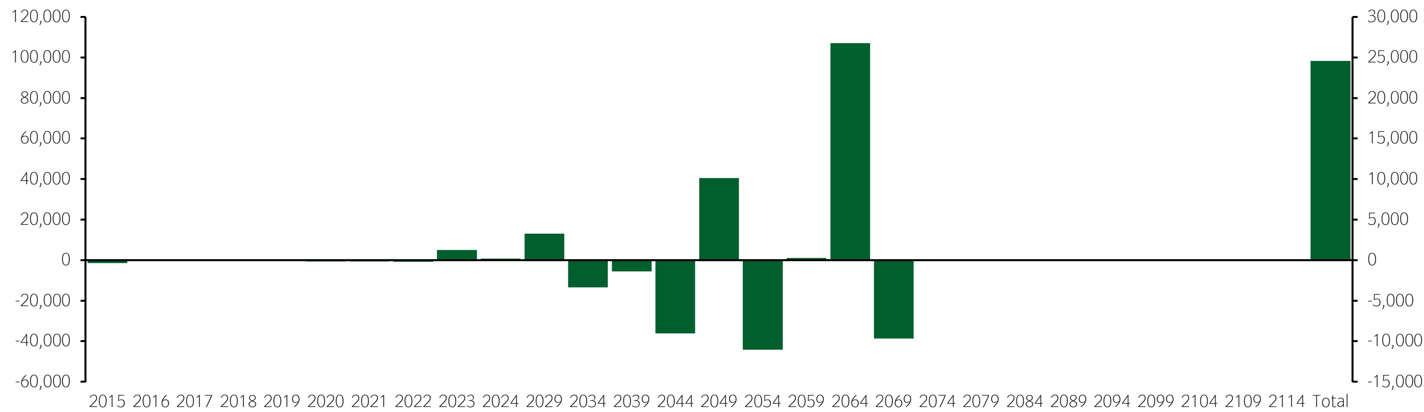
Interest Rate Risk (PV01)
Assets vs Liabilities (£)



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 (£)



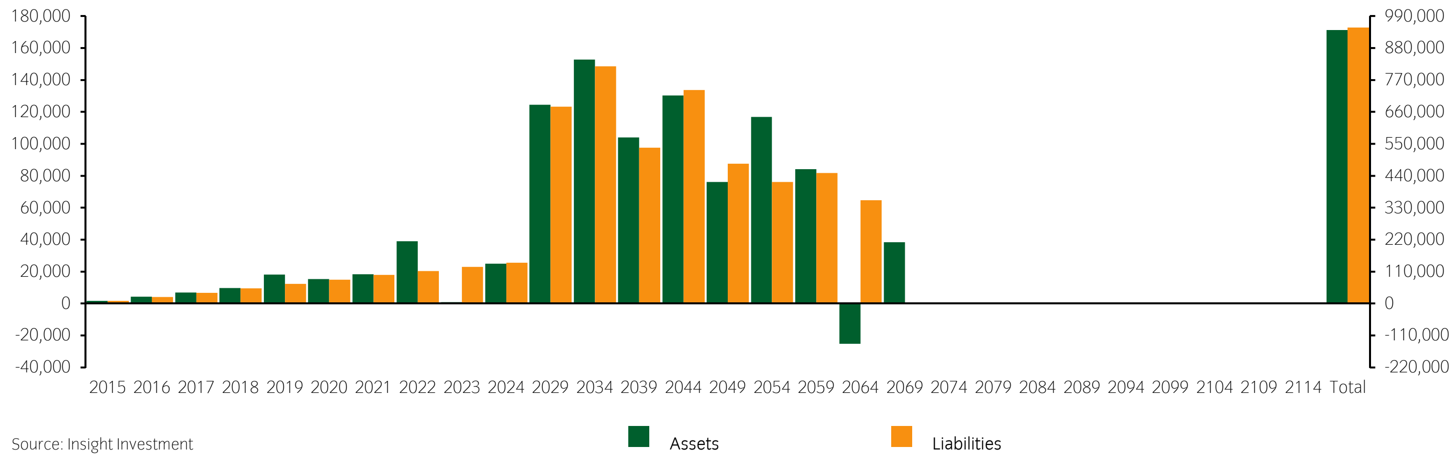
Source: Insight Investment

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

LDI Analysis Continued

Inflation Risk (IE01)

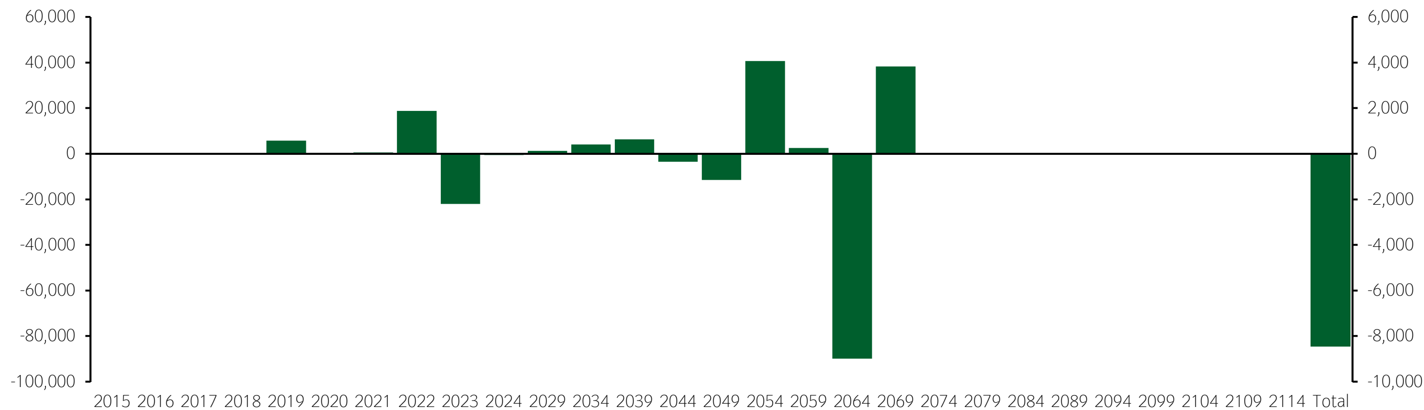
Assets vs Liabilities (£)



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

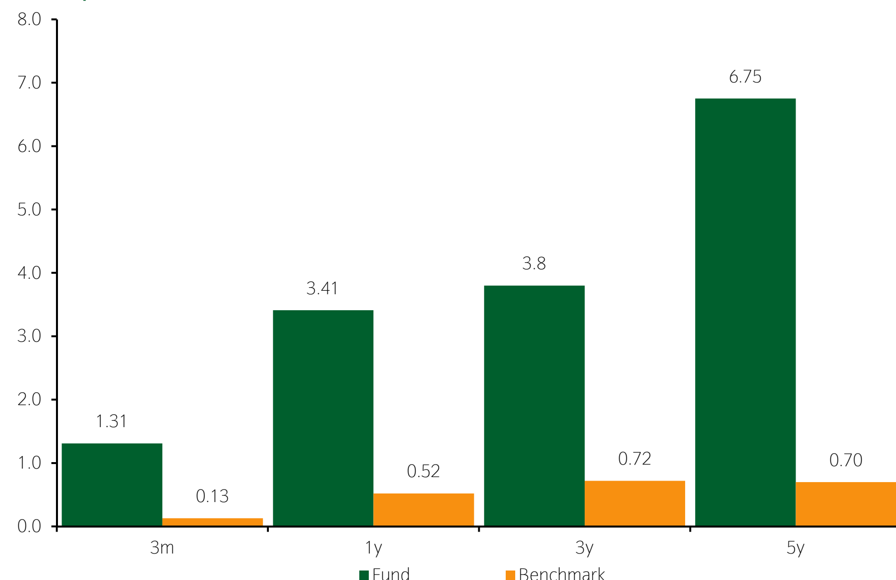
Note: Liability benchmark sensitivities will equal asset sensitivities where no liability benchmark is available

Insight Investment Funds

DORSET LIABILITY MATCHING PORTFOLIO

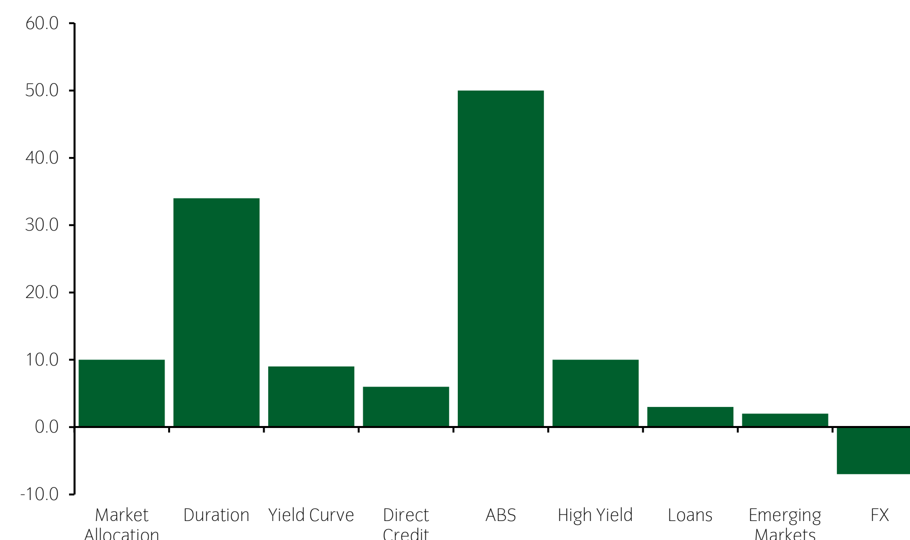
Insight Bonds Plus Fund

Fund performance as at 31 March 2014



Benchmark refers 3 Month GBP Libor. 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

Bond performance relative to benchmark by investment approach (bps)



Please note: the performance attribution has been calculated using Barclays POINT Attribution system. Due to minor timing and occasional pricing differences, the relative performance used in the attribution analysis may differ slightly from actual audited relative performance.

Fund Manager Comments

There was a significant increase in volatility across a number of areas in January, with many investors' positions being severely tested. However, February and March were much quieter months. Against this backdrop, the Fund outperformed its benchmark during the quarter, highlighting the benefits of a diversified approach not reliant solely on the performance of riskier markets. Within government bond markets, we had a number of strategies in place. The Fund held the view that a large degree of interest rate normalisation had already been priced in for the US and UK markets during 2013: five-year gilt yields in five years' time (known as the 5-year/5-year forward yield) had reached almost 4.5%, a level at which we were happy to own long duration positions. In the event, yields in the UK, US and Europe fell, the move being exacerbated by the consensus underweight position in government bonds that prevailed among many investors. Towards the end of the quarter, we moved to lock in a large portion of the profits made as our forecasts in this market have now largely been reached. Elsewhere, the Fund's overweight allocations to Spain and Italy were also positive. During February we added a short position in Japanese government bonds, where yields had fallen to less than 0.5%. We do not predict a sharp upwards move in the near term, but as an option on this happening at some point in the medium term, we view it as a very cheap insurance policy.

Insight Bonds Plus Fund Continued

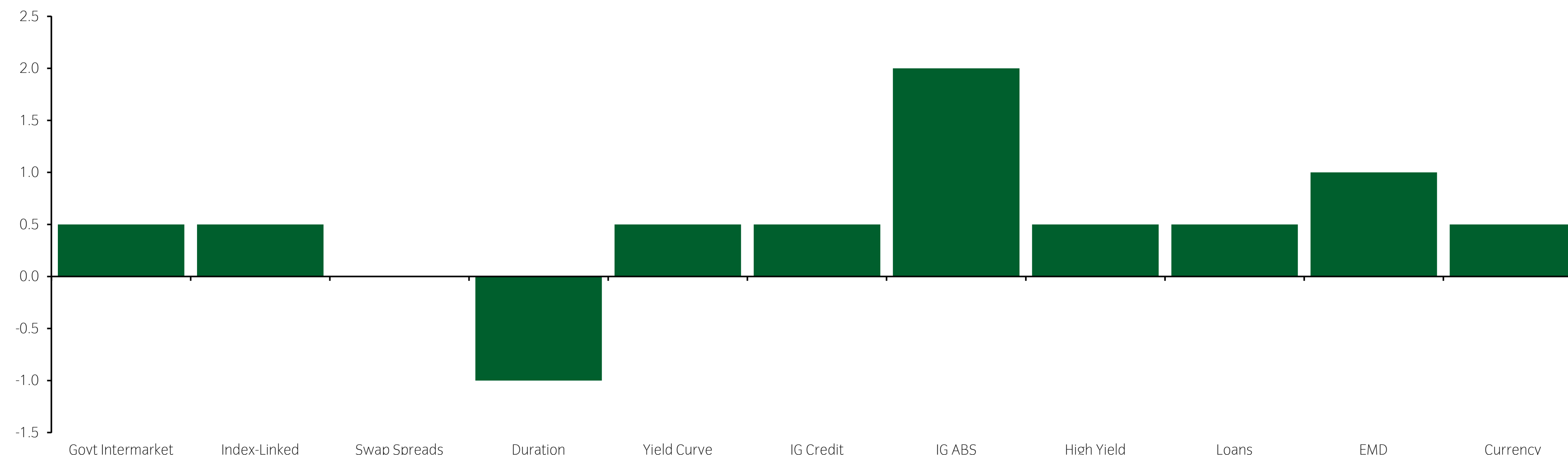
We continued to see positive returns from our allocations to asset-backed securities (ABS), loans and short-dated high yield, with the first area the main contributor. All three asset classes share a lower correlation with interest rate sensitive markets as they have little or no embedded duration, and in the case of ABS should continue to benefit from a gradual re-rating to lower yield levels as investors seek better risk-adjusted returns. In investment grade credit, we held a combination of long and short positions with little outright directional exposure.

In emerging market debt, we had a defensive stance on the asset class for most of the quarter, with little directional risk. Our focus was on long and short strategies that were less correlated with other risk assets and less affected by the volatility in global interest rate expectations. During March, we started to add modest amounts of risk. It is likely that we will add more directional risk in this area in the future given the recent improvement in valuations.

Currency was overall a negative contributor to performance. In particular, long positions in the US dollar versus a basket of other currencies, notably the Australian dollar, detracted from returns. However, we retain the long in the US dollar versus this and other developed currencies as a long term view.

Insight Bonds Plus Fund Continued

Units of Risk allocation as at 31 March 2014



Units of risk explanation

Insight's proprietary "units of risk" system allows us to normalise risk across a diversified set of investment opportunities, to ensure that investment views are implemented consistently within and across client portfolios. For example, the system ensures that a unit of risk of duration is equivalent, in risk terms, to a unit of risk of credit allocation. The units of risk provide an informative snapshot of where we see opportunity and how we have positioned the portfolio, along with an indication of our level of conviction in each of the areas. Positive and negative units of risk do not net off against one another. Where relevant, a negative unit of risk indicates an underweight or short position. Additionally, the total number of units of risk will not necessarily remain the same but will be a function of the opportunities we are able to identify in the market. Units of risk provide a useful overview of positioning but it is important to remember that the fund is highly diversified. For example, the currency position might incorporate numerous different trades and the credit exposure will be diversified across many different sectors and names.

Insight Bonds Plus Fund Continued

Interest rate exposure by currency

Sterling	0.2
US dollars	-0.3
Euros	0.2
Other	-0.7

Credit and emerging market exposure

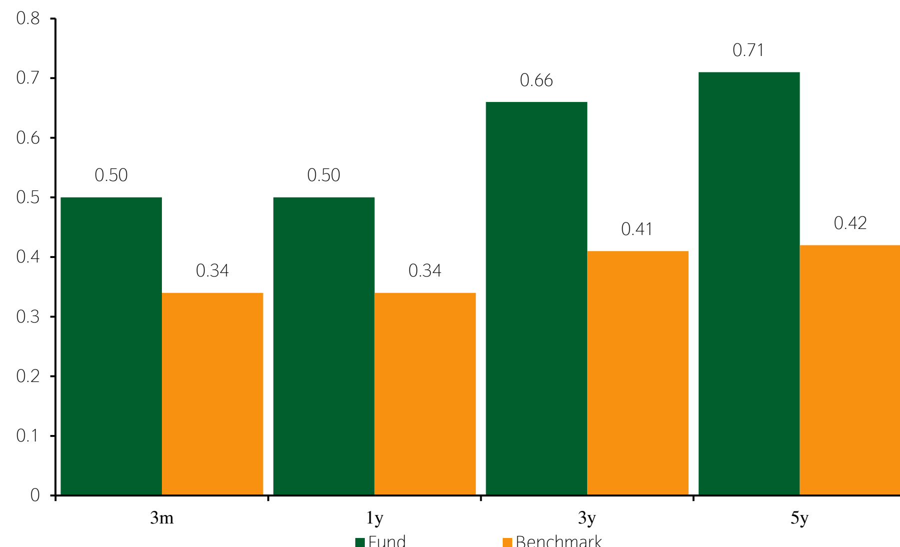
Investment grade	11.7
High Yield	3.6
Loans	7.3
Emerging market debt	4.6
Securitised	21.9

Top 10 currency exposures

Pound sterling	99.7
Japanese yen	-0.8
Swiss franc	-0.7
Mexican nuevo peso	0.5
Brazilian real	0.5
US dollar	-0.4
New Zealand dollar	-0.3
South African rand	0.3
Euro	0.3
Norwegian krone	0.3

Insight Liquidity Sterling Fund

Fund performance as at 31 March 2014



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

Fund Manager Comments

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. The Bank's governor Mark Carney declared that interest rate policy would no longer be tied to the unemployment rate alone. 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 portfolio. The weighted average maturity of the Fund was 38 days at the beginning of the quarter and rose to 43 days by the end of the period. The Fund returned 0.12% over the quarter gross of fees, outperforming its benchmark, 7-day sterling Libid, which returned 0.08%. The Fund's duration and yield curve positioning were positive for returns relative to the benchmark.

Insight Liquidity Sterling Fund Continued

Fund Breakdown by Asset Class

Certificates of deposit	42.2
Commercial paper	24.0
Corporate floating rate	2.9
Government Bond	7.9
Supranational	0.2
Time deposits	22.8

Top 10 holdings

Call Account Lloyds	9.0
Call Account Credit Agricole Corp and Inv Bank	4.5
TD Banques Populaires Caisses d'Epargne 0.25% 01.04.2014	3.6
TD BNP Paribas 0.32% 01.04.2014	2.6
UK Bonds 28.04.2014	2.6
Z/C CP Bank Nederlandse Gemeenten 28.04.2014	1.9
Z/C CP Societe Nationale des Chemins de Fer Francais 14.04.2014	1.6
Z/C CP Societe Nationale des Chemins de Fer Francais 07.04.2014	1.5
Repo Toronto Dominion Bank 0.40% 25.03.2014	1.3
FRN Rabobank 14.11.2014	1.3

Credit Rating Breakdown

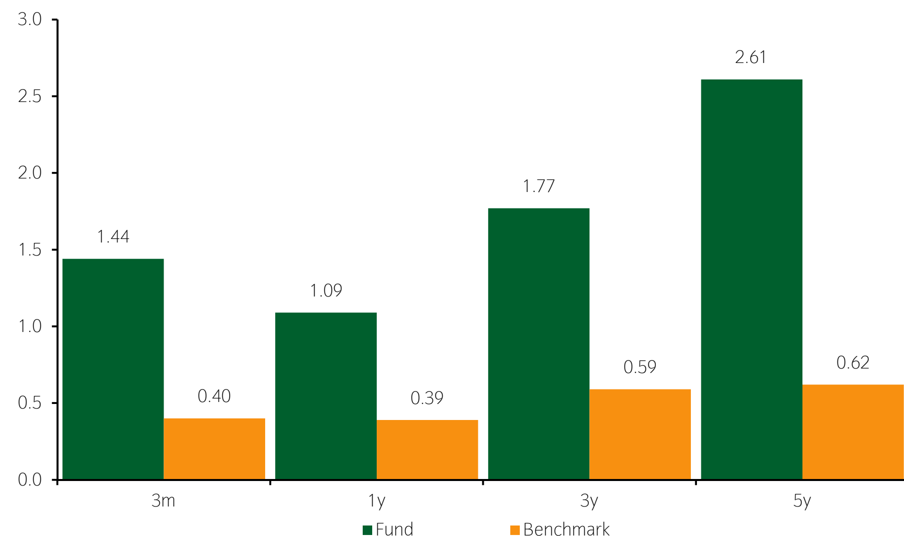
A1+	71.6
A1	28.4

Maturity Profile

1 day	24.8
2-7 days	11.9
8-30 days	15.3
31-90 days	32.4
91-180 days	15.5
181 days +	0.2

Insight Liquidity Sterling Plus Fund

Fund performance as at 31 March 2014



Benchmark refers to 3 Month GBP Libid. Source: Insight Investment. Basis: Annualised total return, gross of all fees and expenses.

Fund Manager Comments

In terms of activity, we added several names to holdings, including issues from BFCM, Nordea, Société Générale, Standard Chartered, Dexia and Barclays in the certificates of deposit and commercial paper portfolio, and covered bonds from Lloyds Bank and Abbey along with issues from New Zealand bank ASB, Credit Suisse, BPCE and BNG in the floating rate notes portfolio. In the latter portfolio we sold issues from Rabobank, ANZ, the European Investment Bank, Bank of Montreal and the Commonwealth Bank of Australia. In asset-backed securities, there was little change in spreads and little new issuance, and we made few changes to holdings. We added Granite in February and bought one new issue, Lanark, in March. We continued to trade short-dated gilts over the period. The weighted average maturity of the Fund began the quarter at 50 days, and stood at 56 days at the end of the quarter. The Fund returned 0.36% over the quarter gross of fees, outperforming its benchmark, 3-month sterling Libid, which returned 0.10%. Asset allocation was positive for returns over the quarter as a result of positive carry and rolling over floating rate notes.

Insight Liquidity Sterling Plus Fund Continued

Fund Breakdown by Asset Class (% of Fund)

Asset Class	% of Fund
Certificates of deposit	19.5
Commercial paper	3.6
Corporate floating rate	39.2
Mortgage-Backed	20.7
Asset-Backed	0.0
Money Market Fund	9.6
Supranational	2.9
Repurchase agreement	-1.2
Sovereign Fixed Rate	5.8

Top 10 holdings (% of Fund)

Holding	% of Fund
Insight Liquidity GBP Fund	9.4
FRN GE Capital 09.05.2016	2.4
MBS Perm Master Issuer 2.17% 15.07.2042	2.2
FRN Commonwealth Bank of Australia 22.07.2016	2.1
CD Deutsche Bank 0.81% 14.04.2014	2.1
CD Standard Chartered 0.61% 17.09.204	2.1
FRN Abbey National Treasury 16.02.2015	1.9
FRN Australia Bank 12.11.2016	1.6
CD Societe Generale 0.59% 31.07.2014	1.6
UK Bonds 1.25% 22.07.2018	1.4

Credit Rating Breakdown (% of Fund)

Rating	% of Fund
AAA	32.7
AA+	5.0
AA	0.2
AA-	16.2
A+	3.5
A	6.2
A1+	17.9
A-1	18.3
A-	0.1

Maturity Profile (% of Fund)

Maturity	% of Fund
1 year	45.9
1-3 years	32.1
3-7 years	2.4
7-10 years	0.2
10+ years	19.5

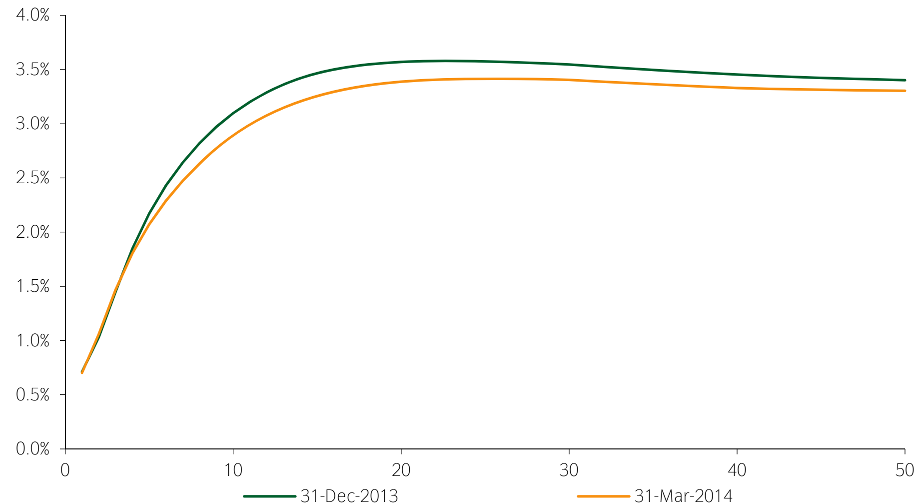
Investment Analysis

DORSET LIABILITY MATCHING PORT

For the period 01 January 2014 to 31 March 2014

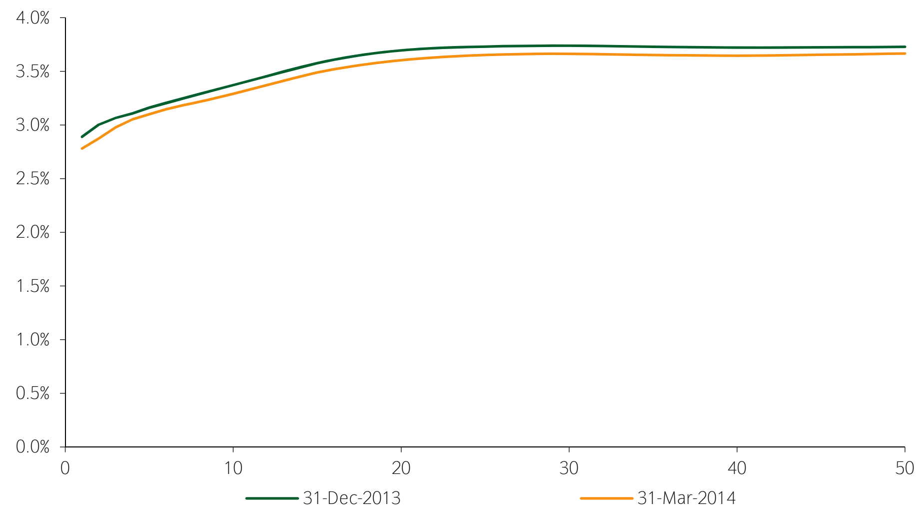
Sterling LDI

Interest rate swap rates (%)



Source: Xenomorph broker quotes composite

RPI swap rates (%)



Source: Xenomorph broker quotes composite

Market review

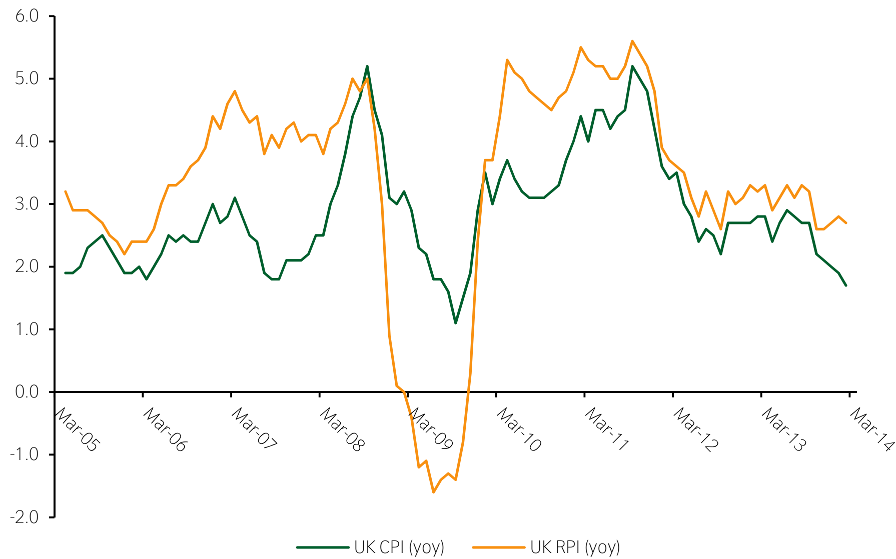
- The major story for pension schemes over the quarter was the UK Budget, released in March, which announced that people with defined contribution ('DC') pensions would no longer be required to purchase an annuity on retirement, increasing the desirability of DC schemes. This sparked concerns about a potential increase in the volume of transfers out of defined benefit ('DB') schemes. The market reaction was a fall in the price of gilts, although this was partially stymied by the government's consultation on pensions. The consultation was released alongside the Budget and suggests plans to limit transfers from DB to DC schemes.
- International events weighed on investors; the start of the year saw emerging market weakness lead to an unexpected rally in global bonds, pushing yields down. As the quarter progressed, attention shifted to geopolitical instability in the Ukraine. This brought about a "risk off" attitude, although this was partially allayed in the latter part of March as the situation did not seem to be deteriorating.
- Strong domestic data as we entered the year boosted investor confidence. Lower inflation and unemployment pushed gilt yields higher, with the Governor of the Bank of England, Mark Carney, announcing a move away from the direct link between unemployment levels and interest rate policy that had been established by forward guidance.
- Throughout the quarter, the BoE kept rates constant at 0.50% and Quantitative Easing (QE) unchanged at £375bn.
- Conventional gilt z-spreads fell at shorter maturities and rose slightly at longer maturities. Index-linked gilt z-spreads also fell, with moves at the longer maturities more pronounced. The 2042 linker z-spread finished the quarter at 23bp.
- Real swap rates fell, with the 20 year tenor falling back 10bp to -0.20%. Similar movements were seen in nominal interest rates; the 20 year swap rate fell 18bp to 3.41%. RPI swap rates moved lower across the curve, with the 20 year tenor moving by 8bp down to 3.51%.

Fixed Income Market Review

UK

UK gilts made a positive return over the quarter, returning 2.1%. Yields fell across the curve, with the biggest movement seen in 10 to 15 year maturities. 10-year gilt yields came in from 3.0% to 2.7%. Gilt yields fell substantially in January as the combination of weaker-than-expected economic data from several emerging markets including China, coupled with soft data from the US, drove investors back into government bonds. This more than reversed the sell-off in December. The gilt market drifted sideways for the remainder of the quarter.

Chart 1: UK inflation (%)



Source: Bloomberg

The UK economy showed signs of continuing growth. While official data showed that economic growth slowed slightly in the fourth quarter, it revealed the UK economy grew by 1.9% in 2013, marking the strongest year of growth since 2007. PMI data for February indicated that manufacturing activity had increased for the 11th month in a row. Services and construction also continued to show robust growth, which helped boost service sector business confidence to a record high. The latest data showed that unemployment fell from 7.6% to 7.2% over the final quarter of 2013, close to the Bank of England's previously stated 7% threshold at which it would re-evaluate interest rates. However, BoE Governor Mark Carney signalled a change in approach, declaring that the Bank of England's interest rate policy would no longer be tied to unemployment alone. There was no change to monetary policy over the quarter, with core interest rates held at 0.5% and the asset purchase scheme at £375 billion. UK CPI inflation fell below the Bank of England's 2% target for the first time since 2009, rising 1.9% in January and 1.7% in February (Chart 1). The lower rate was due to smaller contributions from tuition fees, airfares and energy and food prices. The UK budget announced in March was fiscally neutral. Planned gilt issuance for the next fiscal year is £128.4 billion, a significant reduction on the current year.

The FTSE British Government Index-linked All Stocks index returned 3.2% over the quarter. Real yields fell across the curve, with shorter maturities seeing the biggest decline in yield. The yield curve steepened as shorter and medium-dated bonds outperformed. Real yields in 30-year maturities declined by 12bps, ending the quarter at 0%. Break-even inflation rates fell at the front end of the curve on concerns about lower inflation figures. There was a further syndicated offering of 50-year inflation-linked gilts in January, which was taken up well by the market.

Fixed Income Market Review Continued

US

US Treasury prices yields fell over the first quarter, particularly in January on softer economic data and poor newsflow from several emerging markets. They were further supported by geopolitical concerns centred on Russia and Ukraine, which led investors into the safe havens of government bonds. Treasuries then weakened in March as economic data started to show signs of improvement. Over the quarter, yields rose in 2-year maturities but fell across the rest of the curve, with the biggest moves seen at the long end. The 10-year yield fell from 3.02% to 2.75% over the quarter.

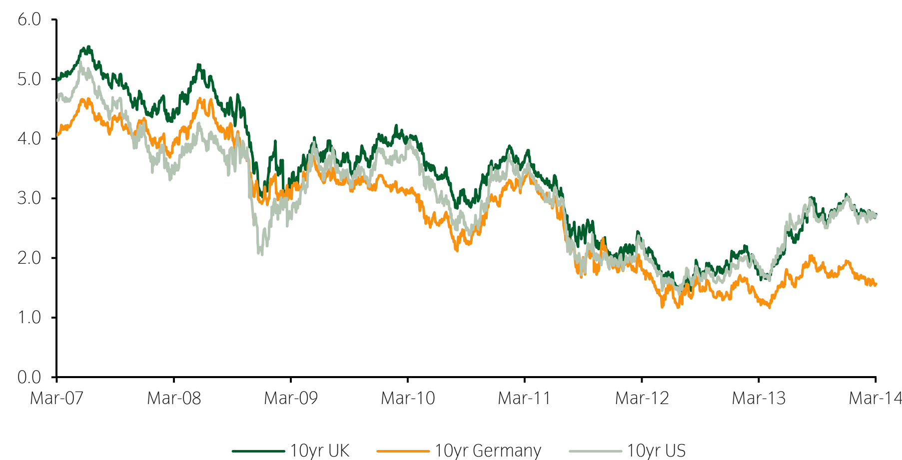
Economic data showed signs of weakening at the beginning of 2014, perhaps in part due to extreme weather conditions in the US, which caused factories to close. According to the Federal Reserve (Fed), industrial production declined 0.2% in January, and then recovered slightly to rise 0.6% in February. Manufacturing output rose 0.8% in February, nearly reversing its January decline of 0.9%. Durable goods orders fell 1.3% in January but then recovered in February to rise by 2.2%. Meanwhile GDP growth for the fourth quarter of 2013 was revised to 2.6%, largely due to an increase in personal consumption. The annual CPI inflation rate was 1.1% in February, down from 1.6% in January and well below the Fed's target of 2%.

Market attention was focused on new Fed Chair Janet Yellen's first FOMC meeting in March. The Fed announced that it would cut its asset purchase programme by a further $10 billion, taking it to $55 billion per month. The Fed also dropped its 6.5% unemployment rate for forward guidance on rates (Chart 2), saying that it would consider a wider range of measures. At the press conference, Janet Yellen indicated that borrowing costs could start to rise "around six months" after the asset purchase programme ends, which was sooner than the market expected. Short-dated bond yields rose as a result.

Chart 2: US unemployment rate (%)

Source: Bloomberg

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



Source: Bloomberg

Fixed Income Market Review Continued

Europe ex UK

Core European bond markets rose across the quarter, following other global bond markets. Prices moved higher in January as the combination of weaker-than-expected economic data from several emerging markets including China, coupled with soft data from the US drove investors back into government bonds. German bund prices were further supported by geopolitical concerns centred on Russia and Ukraine, which led investors to seek safe havens. Yields fell across the curve, with the biggest move seen in 5 to 10-year maturities. German 10-year bund yields fell over 30bps to 1.55%.

In peripheral Europe, spreads over German bunds tightened further as the situation continued to stabilise (Chart 4). Italian 10-year yields fell from 4.08% to 3.32% and Spanish 10-year yields followed suit, falling from 4.22% to 3.24%, their lowest levels since before the financial crisis.

The eurozone economy continued to show signs of recovery in the first quarter. It was reported that the region's GDP grew by 0.3% in the last quarter of 2013, up from 0.1% growth in the previous quarter. The Netherlands led the recovery, expanding by 0.7%, while Germany grew by 0.4%. The figures were boosted by exports and capital investment, while domestic demand was still weak. Italy registered 0.1% growth, its first expansion since 2011. Eurozone composite PMI figures indicated ongoing growth in manufacturing and service activity, led by Germany. French PMI data was weak in February but recovered in March. The eurozone's unemployment rate was little changed at 11.9%. Inflation continued to be below the European Central Bank's (ECB) 2% target, as the March figure fell to 0.5%, down from 0.7% in February. Despite continuing speculation that the ECB would act to stave off the prospect of deflation, the primary interest rate was held at 0.25%. At the press conference, ECB President Mario Draghi said that he considered the risk of eurozone deflation to be "quite limited."

Chart 4: Spanish and Italian yield spreads (%)

Source: Bloomberg

Investment Grade credit

The investment grade credit markets continued to strengthen in the first quarter. Spreads in the US and Europe tightened over the three-month period (Chart 5). UK credit spreads tightened initially and then widened again to end the quarter almost unchanged. The UK market lagged Europe and the US as the announcement in the UK Budget about changes to annuity regulations led to uncertainty about future demand for long-dated corporate bonds.

More lowly rated corporate bonds outperformed more highly rated bonds as investors sought out higher yields. Higher-beta sectors such as financials outperformed. The new issue market continued to be very active. The last week in the quarter saw a surge in European corporate issuance as Anheuser-Busch InBev, Telefonica and Volkswagen amongst others took advantage of record low yields. New issues were generally heavily over-subscribed although they were less attractively valued than

Fixed Income Market Review Continued

previously. There was increased issuance of hybrid bonds and contingent convertibles from banks looking to boost capital levels ahead of the regulators' stress tests later this year. Fund flows into corporate bonds continued to be very supportive.

Chart 5: GBP, EUR and USD credit spreads (%)

Source: Merrill Lynch, Bloomberg

Emerging market debt

Emerging market debt posted positive returns over the quarter, despite starting the period very weakly. January saw a series of negative news stories including weaker economic data from China, emergency attempts by some central banks (such as Turkey) to combat pressure on their currencies with rate hikes and increased political uncertainty stemming from protests in Thailand and Ukraine. As a result, emerging market debt weakened despite the drop in US treasury yields in January. In February geopolitical concerns intensified over Ukraine, and yet the asset class started to recover. The key theme was differentiation between central banks' policy-making: assets in countries where the degree of policy adjustment needed has decreased and where central bank credibility has increased tended to outperform. In March, the market initially weakened because of the escalation of tension between Russia and Ukraine but then rebounded in the last week of the month. The improvement in sentiment towards emerging markets was due to a number of factors: a de-escalation of the conflict in Ukraine; growing market expectations of counter-cyclical policy measures in China; a better-than-expected credit rating for Brazil and continued policy adjustments across the emerging market universe.

The external JP Morgan EMBI Global Diversified index rose 3.73% over the quarter. By region, Africa and Asia were the best performers. Spreads over US treasuries widened from 308 bps to over 360 bps in January, as risk appetite diminished in the light of the negative newsflow. Spreads then narrowed for most of the rest of the period, ending the quarter at 291 bps. Corporate bonds also saw positive performance: the JP Morgan CEMBI Broad Diversified rose 2.79%, with investment grade outperforming high yield. Local bonds underperformed external bonds with the local benchmark JP Morgan GBI-EM Global Diversified index rising 1.90%.

High yield

High yield markets carried on their rally in the first quarter of 2014 as investors continued to search for yield. Retail money flows into the asset class were strong and new issue supply was limited. The market experienced some weakness in the second half of January when poor newsflow from emerging markets and weaker economic data in the US weighed on investor sentiment, but soon recovered.

The spread on the CSFB High Yield index started the period at 395 bps and widened slightly over January. Once the concerns over emerging markets had diminished, spreads started to narrow again and ended the quarter at 344 bps, well below the long-term average but still above the all-time lows. Yields fell to 4.08% by the end of March. In new issuance, the year began strongly with €10 billion of issuance in January, but this halved to €5 billion in February because of lingering concerns over emerging

Fixed Income Market Review Continued

markets. March was also slower ahead of earnings releases. New issues were heavily oversubscribed and less attractively priced than previously. Issue size also declined over the period.

Loans

The loans market made a positive return over the quarter. The year started slowly, with a series of mainly US-originated cross-border syndications. Towards the end of January Ziggo launched a €3.7 billion loan merger and acquisition financing, which was placed amongst US and European investors, demonstrating the depth of liquidity in the loans market. A number of opportunistic sponsors came to the market, such as Bureau van Dijk which launched a €670 million recapitalisation. As the quarter ended, activity picked up markedly with a mixture of refinancing and leveraged buy-out loans on offer.

New issuance remained strong, with 44 new deals over the quarter totalling €14.6 billion. Primary collateralised loan obligation (CLO) issuance was also robust, with €1.4 billion of European CLO new issues in February. This continues to act as positive technical driver for the loan market both from a psychological and actual trading perspective. On the negative side, there were several defaults over the quarter and the default rate increased to over 4%. This was in contrast to 2013 when the default rate was on a downward trend, ending the year at 2.9%.

Asset-backed securities

The asset-backed securities (ABS) market made a positive return over the quarter. The market is technically undersupplied against a demand dynamic which continues to see inflows from other asset classes as well as from non-European investors (increasingly the US and Asia). For this reason, ABS were resilient through the increased volatility caused by poor newsflow from emerging markets and weakening economic data, which weighed on broader credit markets in January.

Over the quarter, higher beta issues strongly outperformed lower beta issues as investors continue to search for yield. Spreads gradually tightened, with the sharpest moves seen in securities based in peripheral Europe, where credit yields mirrored government bond yields by falling markedly. There was increased primary activity during the quarter, with a number of CLOs issuing, as well as consumer transactions. Issuance from peripheral markets picked up, particularly in Italy.

Currency

In the first quarter of 2014, currency markets were broadly driven by weaker-than-expected economic growth, particularly in the US.

In January, weakness in emerging markets, combined with worries about the economic impact of cold weather in the US, led government bond yields to fall as investors bought bonds as a safe haven. Emerging market currencies weakened. The Japanese yen (JPY) rallied as investors cut their long positions in Japanese equities and short positions in the JPY, while the Australian dollar (AUD) depreciated as events in emerging markets and the broader risk aversion weighed on the currency.

In February, US economic data remained weaker than expected, possibly due to the ongoing impact of the extreme weather. The additional uncertainty about US growth led bond yields to fall further, which resulted in a weaker US dollar (USD). The USD weakness supported the AUD and some emerging market currencies. In an unexpected development, the Chinese yuan depreciated as authorities deliberately weakened the currency, possibly to discourage speculative inflows as a precursor to ongoing financial market liberalisation.

In March, the ongoing lack of clarity over the outlook for US growth meant that longer-dated US bond yields traded within a broad range over the month, and the USD followed suit, trading sideways against major currencies. Low market volatility and good performance in risk assets meant that investors bought cyclical and higher-yielding currencies, and so emerging market currencies and the AUD did better over the month.

Investment Outlook

DORSET LIABILITY MATCHING PORTFOLIO

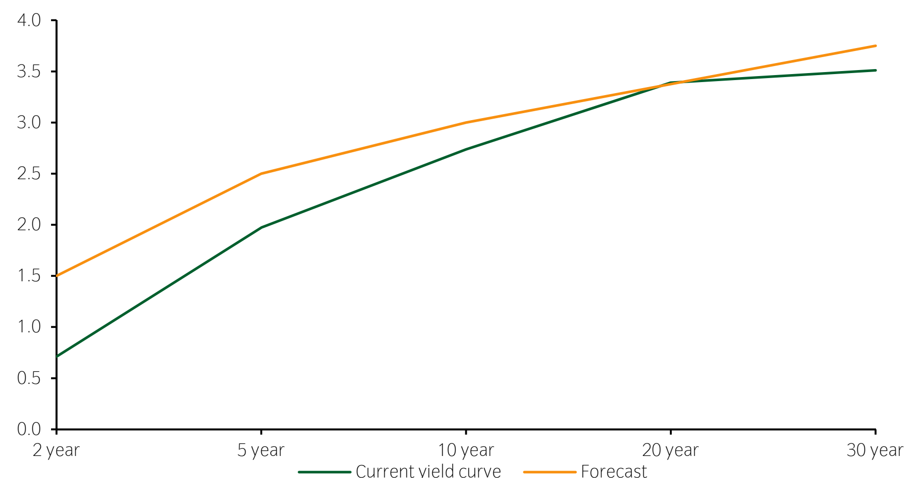
For the period 01 January 2014 to 31 March 2014

Fixed Income Outlook

UK

The UK has continued to enjoy positive tailwinds, with sequential improvements in housing and labour markets feeding through into rising indicators of household and business confidence. We view the rapid improvement in residential investment in 2013 as linked to the Funding for Lending scheme and the dovish policy stance of Bank of England Governor Carney. However, over the past months the labour market has improved rapidly, bringing forward expectations of a rate hike relative to the official growth forecasts. Carney has therefore shifted the focus from unemployment as a threshold for tighter interest rate policy to the use of more nuanced macro-prudential policy tools. For now, credit availability is improving and we expect the positive momentum to continue. The consensus view on interest rates is that the first increase will come after the 2015 general election. We expect the peak of the interest rate cycle to be 2-3%. The upwards movement in yields over the past year now mean that a lot of bad news is already priced in. We would expect yields to drift only slightly higher from here.

UK gilt yield forecast (%)



Source: Bloomberg

Europe ex UK

European growth was sub-par throughout 2013. Bank asset quality was a pressing issue that restricted lending, but national regulators appeared reluctant to assess the problem dispassionately. With the ECB taking control of banking supervision, we expect that its asset quality review should help restore confidence in bank balance sheets when the results are released later this year. Fundamentally, we have seen tentative signs of improvements in competitiveness, partly driven by falling prices in some peripheral countries. The southern European economies that experienced sharp contractions and implemented reforms are now seeing a return to growth. While we have not yet seen significant reforms in France to reduce the size of the public sector, overall, the primary balances have improved sufficiently that in our base case for economic growth, debt/GDP levels are set to fall across Europe. We think the ECB is therefore more likely to pursue stimulative policies if activity or confidence falters. We expect core European bond yields to drift higher from here and spreads on peripheral European bonds to continue to tighten.

US

The improvement in economic data has stalled in the first few months of 2014: we believe that this is due to the unusually bad weather but remain alert to the possibility that it heralds a broader slowdown. The Fed has continued winding down their asset purchase programme, with a small reduction in the volume of purchases likely at each of the next few meetings, assuming that economic activity stabilises. We expect this process to finish in the second half of 2014.

We are increasingly confident that rates will start to rise in early 2015. We base this assumption on the fact that unemployment is moving steadily lower and is likely to soon converge on the Fed's assessment of the neutral longer term unemployment rate of 5.2-6%. Historically, the Fed would have viewed that level as the time at which rates should be neutral, which in their view is between 3.5% and 4.25%. We do not expect rates to rise anything like as quickly as historic precedents would suggest but we

Fixed Income Outlook Continued

do expect that rates will need to start rising steadily from early next year. If this is the case, it is likely that short-dated yields would continue to rise faster than long-dated yields.

Investment grade credit

We believe that the current environment for corporate bonds 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 as investors continue to search for yield. We therefore expect investment grade credit spreads to narrow further.

As long as the withdrawal of monetary stimulus in the US does not lead to a disorderly sell-off in US Treasuries, we believe credit markets should be unaffected by a gradual rise in interest rates. We continue to prefer financials (especially banks) over industrials, on valuation and leverage trends. A rise in corporate leverage remains a risk to credit fundamentals and consequently we prefer companies which have already completed expansion plans. We are cautious on any long-dated sterling issues which are tightly priced relative to non-sterling markets. We have a preference for bonds that offer security over assets such as securitised bonds, loans and asset-backed securities.

Emerging market debt

We believe that the year-long vicious cycle of emerging market debt underperformance may have ended and the high risk premium attributed to all emerging market asset classes since the Federal Reserve announced the beginning of the end of quantitative easing last May will continue to normalise towards lower levels.

The main risks to emerging market debt are unchanged: US interest rates; China; any signs of weakening global growth. However, the asset class's attractive valuations (for example emerging market corporate spreads are at their highest versus US corporates since 2008), improved technical situation (light investor positioning and lower issuance), better quality of policymaking and de-escalation of political issues have clearly tilted the pendulum towards a positive stance towards emerging markets. A virtuous cycle may have begun.

High yield

Interest rate risk and emerging market fund flows continue to be the largest threat to fixed income, whilst new issue supply coupled with cash balances and fund flows will drive the direction of the high yield market going forward. New issuance in 2014 is likely to remain very strong given the continued need of bank to cleanse and reduce their balance sheets, primarily in peripheral Europe. Fund inflows into the asset class are likely to remain solid, albeit at a more moderate pace given the lower yield of the asset class.

Short-dated high yield remains a compelling investment as it provides the most attractive risk-adjusted method of investing in this asset class given the overall yield compression. Short-dated high yield opportunities are becoming rarer and riskier, as companies have taken care of their short term maturities, and we may be forced to take on more call risk. Stock picking is of paramount importance in this environment. Excessive new issue supply coupled with issuer quality and profit warnings should provide us with opportunities to add risk during the year at slightly more attractive levels than we see today.

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.

Fixed Income Outlook Continued

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 mortgage-backed securities market, because of the combination of improving economic data and the government support for the housing market; peripheral markets, in particular Spain, where we believe the improving macro-economic climate will lead to tighter spreads and the CLO market, trading at cheap levels because of regulatory uncertainty which we expect to soon be resolved.

Loans

The loans market is well supported, with a great deal of investor interest in CLO issuance and the underlying loans. The supportive backdrop for the asset class has in turn meant that private equity firms are also starting to engage as they can see there is demand for their deals. In 2013 there was €70 billion of new issuance and there is forecast to be €100 billion this year. Spreads have tightened, but there are still attractive deals available. Whilst the outlook for the asset class is very constructive, one still has to tread carefully as there is pricing pressure and documentation is getting weaker. The slew of new restructurings and defaults has also shown that despite the market strength, credit selection remains as critical as ever.

Currency

Looking ahead, our view remains that once weather in the US has returned to normal and there is greater clarity on US growth, bond yields are likely to continue rising. In this environment the USD is likely to perform well. In the meantime, however, currency markets are likely to be more range-bound and we are running little overall USD risk.

Appendices

DORSET LIABILITY MATCHING PORTFOLIO

For the period 01 January 2014 to 31 March 2014

Summary Portfolio Valuation

As at 31 March 2014

	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	199,426,884.56	100.00
Total Sterling	147,957,061.56	100.00	199,426,884.56	100.00
Total Fixed Income	147,957,061.56	100.00	199,426,884.56	100.00
Total	**147,957,061.56**	**100.00**	**199,426,884.56**	**100.00**

Notes

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