Quarterly Report 31 March 2014

Dorset County Pension Fund

Good thinking. Well applied.

TABLE OF CONTENTS

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 March 2014	197.33
31 December 2013	190.25
Change over quarter	7.08
Net cash inflow (outflow)	0.00

EXECUTIVE SUMMARY

Performance

- The fund gave a gross return of 3.72% over the quarter, compared with a benchmark return of 2.96%.
- Outperformance over the quarter primarily reflected sector and stock selection within the fund.

The economy and bond markets

- Investor sentiment weakened, impacted by volatility in Emerging Markets, the crisis in Ukraine and extreme winter weather in the US, distorting local economic data. In the UK, gross domestic product (GDP) rose by 1.7% in 2013, with business surveys suggesting that positive momentum continued in to 2014. UK consumer price index (CPI) inflation fell to a four year low of 1.7%. The headline rate of unemployment in the UK fell to 7.2%, while employment levels rose, although the problem of "underemployment" was highlighted.
- Taking in to account the severe weather effect in the US, recent data suggest a gradual improvement in US economic growth; industrial production and consumer confidence have risen, manufacturing and non-manufacturing Purchasing Managers' Indices (PMIs) have remained positive, while unemployment has fallen to 6.7%. Eurozone GDP grew by 0.3% in the final quarter of 2013, with subsequent data suggesting that the modest growth continued in to 2014; the gap between the pace of growth in periphery and core eurozone countries has narrowed. CPI inflation fell further, raising speculation about a policy shift by the European Central Bank. Economic data in China have been weaker than expected, while in Japan GDP growth slowed to 0.2% in the final quarter of 2013.
- Conventional gilts returned 2.15% over the quarter, with the 10 year yield falling to 2.73%. Issuance was broadly balanced across maturities. Medium dated gilts outperformed long and short dated gilts on a risk adjusted basis. Real yields initially rose, but subsequently fell as geopolitical tensions led to a flight to quality; index linked gilts returned 3.22% over 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. Sterling investment grade credit bonds returned 2.40%, outperforming government bonds. Subordinated financial bonds remained the best performing area, while utilities and consumer orientated bonds underperformed. Credit spreads were unchanged over the quarter. Global high yield bonds returned 2.86% over the quarter.

Investment outlook

- Although having risen from record lows over 2013, and having slipped lower over the first quarter, we expect a further moderate rise in gilt yields; a dramatic sell-off in government bond markets over 2014 is not our central forecast. We believe that long term real interest rates of zero are too low and do not reflect long term economic fundamentals; overseas index linked bond markets offer significantly better value. We believe that the pricing of credit bonds undervalues the asset class. We expect returns from sterling investment grade corporate bonds to exceed government bonds by at least 1.5% p.a. over the next three years.

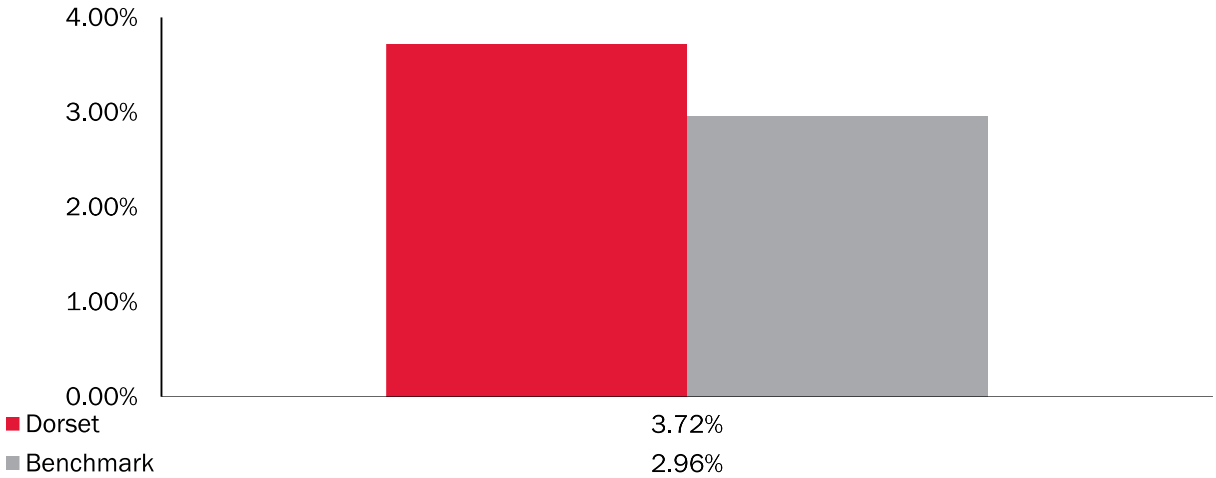
FUND PERFORMANCE

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 (%)
Q1 2014	**3.72**	**2.96**	**0.76**
Year to date	3.72	2.96	0.76
Rolling 12 months	4.02	1.43	2.59
3 years p.a.	13.87	13.76	0.11
5 years p.a.	16.10	9.47	6.63
Since inception 02.07.07p.a.	9.35	9.75	-0.40

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 1 2014

Asset split

	Fund (%)	Benchmark[1] (%)
Conventional credit bonds[2]	99.7	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	0.3	0.9
Foreign index linked sovereign	0.0	0.0
Derivatives	0.0	0.0

Fund data

	Fund	Benchmark[1]
Duration	9.9 years	9.8 years
Gross redemption yield[3]	4.69%	4.16%
No. of stocks	204	719
Fund size	£198.4m	
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 (%)
Q1 2014	**3.63**	**2.96**	**0.67**
Year to date	3.63	2.96	0.67
Rolling 12 months	3.88	1.43	2.45
Since inception p.a. (acc) 02/07/2012[2]	9.89	7.00	2.89

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 account manager.

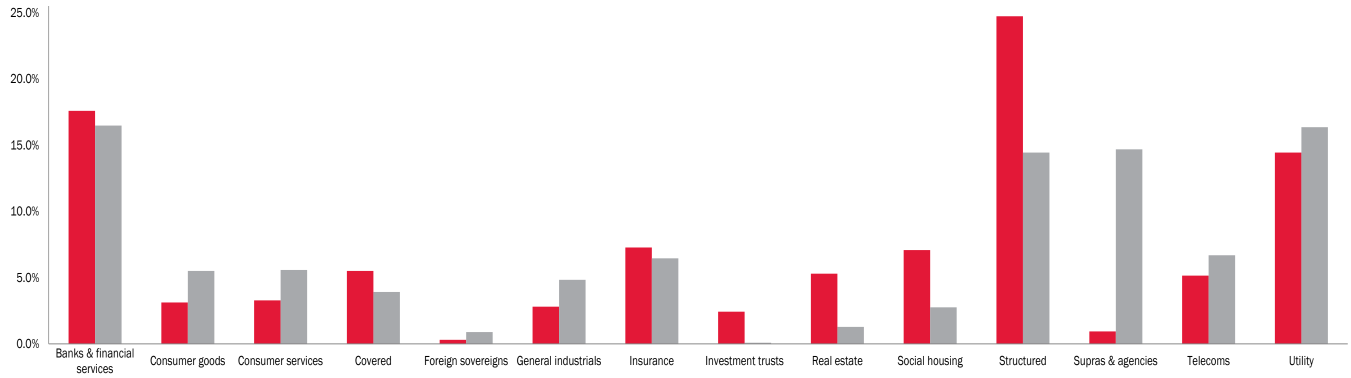
The fund objective is to outperform the benchmark by 0.5% per annum gross of the standard management fees.

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 1 2014

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	17.6%	3.1%	3.3%	5.5%	0.3%	2.8%	7.3%	2.4%	5.3%	7.1%	24.7%	0.9%	5.2%	14.4%
Benchmark	16.5%	5.5%	5.6%	3.9%	0.9%	4.8%	6.5%	0.1%	1.3%	2.8%	14.4%	14.7%	6.7%	16.4%

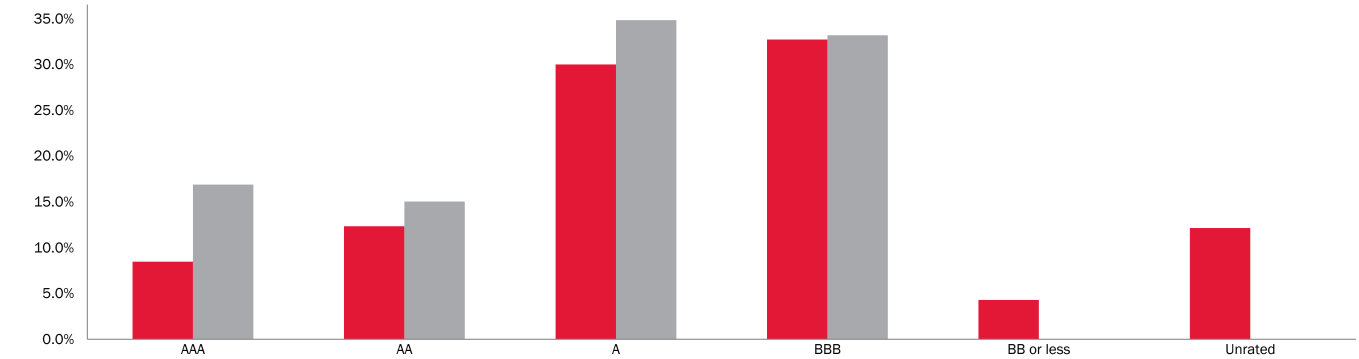
Source: rlam. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio.

What we thought	What we did	What happened	Effect on portfolio
We expected that corporate bonds would outperform supranational debt.	We maintained a low weighting to supranational bonds, a significant stance compared to the benchmark weighting.	Long dated supranational bonds outperformed long dated corporate debt.	The underweight position in supranational debt was a small negative factor in relative performance.
We continued to prefer a combination of covered bank bonds and subordinated bank debt to senior bonds.	We maintained above benchmark exposures to covered and subordinated bank debt.	Subordinated financial bonds continued to outperform strongly, supported by on-going repurchases. Covered bonds saw an improvement in performance.	The strong returns achieved by subordinated bank debt helped performance.
We thought that high profile consumer orientated bonds were unattractively priced relative to corporate debt.	We maintained an underweight exposure to such bonds.	Highly rated, longer dated consumer bonds underperformed, less a result of stock specific issues and more a consequence of fears of reduced demand for these assets from annuity providers following the Budget Statement.	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 which benefit from enhanced security e.g. asset backed securities (ABS), social housing and investment trusts.	ABS performed in line with the overall sterling credit market. Real estate bonds outperformed.	The exposure to secured and ABS bonds was marginally beneficial to performance.

RLPPC OVER 5 YEAR CORPORATE BOND FUND

Quarter 1 2014

Rating breakdown



	AAA	AA	A	BBB	BB or less	Unrated
PPLCP	8.5%	12.3%	30.0%	32.7%	4.3%	12.1%
Benchmark	16.9%	15.0%	34.9%	33.2%	0.0%	0.0%

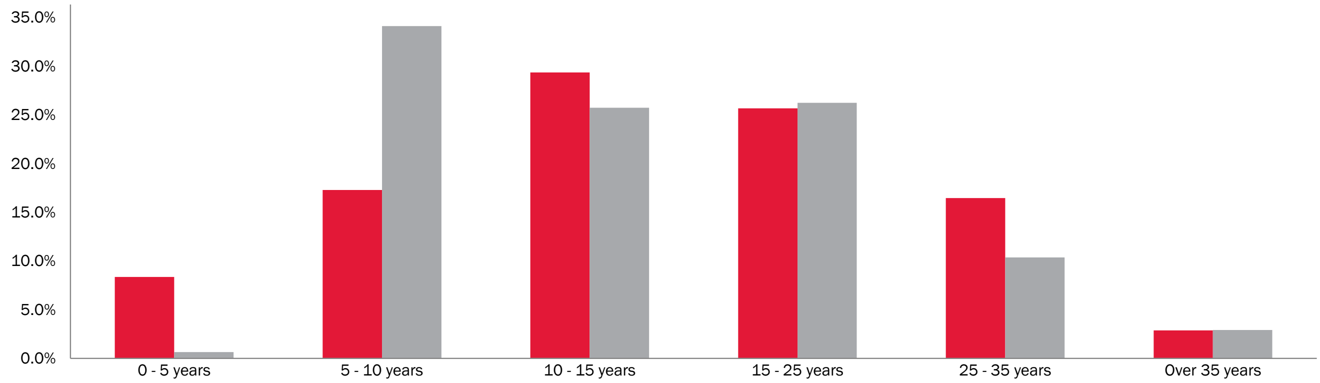
Source: rlam. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio.

What we thought	What we did	What happened	Effect on portfolio
Within credit markets, we believed that lower rated bonds offered better value than AAA / AA rated securities.	We reduced exposure to AAA rated debt over the quarter, maintaining the fund's underweight exposure to higher rated bonds. Exposure to BBB and unrated bonds was increased, primarily reflecting new issue purchases (AXA, Porterbrook and Orange).	While there was little discernable difference in absolute returns between rating bands, on a duration adjusted basis, BBB bonds were the strongest performers over the quarter, returning 0.89% in excess of government bonds. In contrast, AAA rated securities returned a more modest duration adjusted 0.24% above government bonds.	The credit rating profile of the portfolio was beneficial to overall fund performance.

RLPPC UK OVER 5 YEAR CORPORATE BOND FUND

Quarter 1 2014

Maturity profile



	0 - 5 years	5 - 10 years	10 - 15 years	15 - 25 years	25 - 35 years	Over 35 years
PPLCP	8.4%	17.3%	29.4%	25.7%	16.5%	2.9%
Benchmark	0.6%	34.1%	25.7%	26.2%	10.4%	2.9%

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
Despite government bond yields having risen in the final quarter of 2013, we expected a further modest increase over the course of 2014.	The duration of the portfolio did not significantly diverge from that of the benchmark during the quarter.	Government bond yields fell on disappointing global economic data, particularly from the US, emerging market concerns, particularly in relation to China, and rising geopolitical tensions, including Russia's annexing of Crimea.	Duration positioning was not a factor in relative performance.
We believed that credit spreads were most attractive at medium maturities.	We maintained an overweight exposure to medium dated credit bonds.	Throughout the majority of the quarter, there was no significant dispersion of returns across maturity bands. However, following the announcement of pension reforms outlined in the Budget Statement, specifically that pensioners will no longer need to buy an annuity at retirement, longer dated bonds, where annuity providers are significant buyers, underperformed.	Yield curve positioning was a beneficial factor in fund performance.

RLPPC UK OVER 5 YEAR CORPORATE BOND FUND

Quarter 1 2014

Ten largest bond holdings

	Rating	Weighting (%)
Annington Finance 0% 2022	AAA	1.5
Finance For Residence Social Housing 8.369% 2058	AA	1.4
Equity Release Funding 5.88% 2032	A	1.3
Lloyds Bank Plc 6% 2029	AAA	1.3
Abbey National Treasury 5.75% 2026	AAA	1.2
Barclays Bank 10% 2021	BBB	1.0
GE Capital 6.25% 2038	AA+	1.0
Nationwide Building Society 5.625% 2026	AAA	0.9
Electricite de France 6% 2114	A+	0.9
Annes Gate Property 5.661% 2031	bbb (rl)	0.8
Total		**11.3**

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 1 2014

Fund activity

- Reflecting an increase in ultra-long dated corporate bond issuance over the quarter, the fund participated in several notable long-dated new issues. From **EDF Group**, an integrated energy company (generation, transmission, distribution, energy supply and trading) with global sales in excess of €70bn, we participated in an inaugural 100 year bond. We felt that the 6% coupon being offered was very attractive for a diversified utility and felt comfortable with the issuers desire to align its balance sheet with its long lifetime industrial assets. EDF issued £1.25bn, making it one of the largest single transactions in the sterling market in recent years. The **United States of Mexico** also issued an ultra-long dated bond in the latter part of the quarter. We felt that the improved economic situation in Mexico, coupled with the attractive yield, merited a small allocation within the fund. This bond has performed relatively poorly in the secondary market, in contrast to the EDF bond, which has performed exceptionally well.
- **Porterbrook**, a provider of rolling stock to freight and train operating companies, issued a long dated bond in the latter part of the quarter. The bonds were offered at 1.57% over government bond yields, which we considered an attractive level given the long term contracts that underpin the business model.
- **Verizon** launched a dual tranche multi-currency transaction in sterling and euro, as part of its refinancing of the Vodafone stake purchase. The transaction was met with strong demand and the bond has performed well since launch. In addition, a new issue from **Imperial Tobacco** was also purchased, adding to an existing exposure. The bonds were priced at 1.55% over government bond yields, an attractive discount to secondary market pricing.
- There was further issuance of corporate hybrids over the quarter, with the fund taking a small position in hybrid bonds from **Orange**. Hybrid bonds have very long or unlimited theoretical maturities and interest payments can be suspended if no dividends are paid. In addition, hybrid bonds are subordinated, which means that in the event of an insolvency or liquidation, they are serviced only after all senior obligations have been met. However, because of these factors, the interest rates on hybrid bonds are much higher than that of senior bonds. In this case, it was felt that the high relative yield compensated for the increased risk profile.
- New issuance activity in the social housing sector remained strong; we participated in a new issue from of **Bedford Pilgrim Housing Association**. Overall, despite the outperformance seen over recent years we believe that valuations remain attractive.
- In addition, we increased the fund’s weighting to insurance company debt through purchases of new bonds from **AXA** and undertook a switch within the capital structure of **Prudential**. We also added to the position in the **Royal London Sterling Extra Yield Bond Fund**, being an effective way to increase the exposure to higher yielding debt.
- Sales of credit bond were generally limited in the quarter e.g. **EIB**, **Circle Anglia**, **GKN** and **Punch Taverns**. In the latter case the bonds had recovered a lot of their value in recent months and we decided that the uncertainty around the restructuring proposals justified the sale of our position.

Key views within the portfolio

- A significant underweight in supranational bonds, as we expect credit bonds to outperform.
- Duration is broadly in line with that of the benchmark, as we expect long dated gilt yields to rise in 2014.
- 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

- Market sentiment proved a little weaker over the quarter, impacted by volatility in Emerging Markets, the crisis in Ukraine, and weather-related softness in US data.
- The US Federal Reserve (Fed) kept its key benchmark rate at 0.25%, and commenced scaling back its quantitative easing programme, reducing the pace of its monthly bond purchases by $10bn per month.
- The Bank of England Monetary Policy Committee (MPC) altered its forward rate guidance on UK interest rates, to take account of a wider range of variables rather than a single unemployment figure for determining interest rates.
- Economic data in China were weaker than expected

Growth

- Market sentiment was weaker over the quarter following volatility in Emerging Markets, the crisis in Ukraine and a weather-related soft patch in the US.
- The most recent data indicate that the UK economy grew by 1.7% in 2013. Consumer spending and housing investment were the two main drivers, as easing credit conditions led households to reduce their savings rate, while housing transactions rose sharply from a low base. Business surveys suggest that positive momentum has continued into 2014. Real income growth has remained subdued, as has the pace of unsecured lending growth although, for the recovery to be sustained, we will need to see a pick-up in income growth, business investment and net trade. The headline rate of unemployment has fallen to 7.2% and employment levels have risen. However, many people are still in part-time work and an unusually high proportion of part-time workers want to work more, highlighting the problem of "underemployment".
- Allowing for a severe weather effect, recent data suggest that US economic growth remains in line with our base case assumption of a gradual improvement. There are tentative signs that activity began to recover towards the end of the quarter, including a rebound in industrial production. Consumer confidence has also risen, while both manufacturing and non-manufacturing PMIs have remained in expansionary territory. Total employment has continued to rise, albeit at a slower rate than in previous cycles, while the unemployment rate has now fallen to 6.7%.
- Eurozone gross domestic product (GDP) grew by 0.3% in the final quarter of 2013, with subsequent business and consumer confidence indicators suggesting modest growth in the first quarter of this year. There has been a narrowing in the gap between the pace of growth in the Euro-area periphery and the core, as the external competitiveness of some periphery countries has improved, while the perceived tail risks associated with the possibility of sovereign default have fallen. The headline rate of consumer price index (CPI) inflation fell to 0.5% in March and, although some of this is related to the timing of Easter, it has raised speculation about a policy shift by the European Central Bank (ECB).
- Economic data in China have been weaker than expected, signaled by a decline in PMIs, a rise in corporate defaults, and a slowdown in export growth. Industrial production growth fell from 10.0% year-on-year in the final quarter of 2013 to 8.6% year-on-year in January/February. Tighter domestic credit conditions since mid-2013 and the weather-related weakness in the US economy are probable reasons behind the slowdown. Elsewhere in Asia, Japanese GDP growth slowed to 0.2% in quarter four and there is some concern that the pickup in activity seen in 2013 may not be sufficiently well entrenched to withstand the increase in VAT scheduled for April 2014.

Inflation

- Inflation, as measured by the UK CPI, was 1.7% year-on-year in February, reflecting a drop in petrol price inflation. The rise in sterling has helped contain import costs, while global food price inflation has fallen, in response to increased supply. Survey-based measures of inflation expectations also fell during the quarter, while wage pressures remained subdued.

Interest rates

- The ECB maintained its main refinancing rate at a record low of 0.25% and signalled its intention to keep rates low. The Fed kept its key benchmark rate at 0.25% and commenced a reduction in the pace of its quantitative easing programme. The new Chair of the Fed, Janet Yellen, reiterated the commitment to keeping interest rates at their current level for some time.
- In the UK, the MPC altered its forward rate guidance on interest rates to take account of a wider range of variables, rather than a focus on the headline rate of unemployment. The MPC judged that there was scope for the UK economy to recover further before the bank rate was raised and, once increased, expected it to do so only gradually and to a level materially below its pre-crisis average of 5%.

Currencies

- Trade weighted sterling continued to rise over the quarter, as the improvement in UK economic data continued to boost sentiment. The recent appreciation has taken it above the upper limit of its post crisis range.

BOND MARKET REVIEW

Investment grade: financial & corporate bonds

Key points

- Sterling investment grade credit bonds returned 2.40% over the quarter, one of the strongest starts in recent years, and driven by a recovery in UK government bonds after their weakness at the end of 2013.
- Credit spreads ended the quarter unchanged at 1.18%, although this masked differences between sectors.
- Financial bonds, and in particular subordinated debt, again outperformed; only utilities and consumer bonds underperformed UK government bonds.

Credit spreads

- Sterling credit bonds outperformed UK government bonds by 0.31%, duration adjusted.
- Credit spreads narrowed in the early part of the quarter before geopolitical issues in Emerging Markets caused risk assets to weaken and spreads to widen. At the end of the period, the average credit spread was 1.18% above UK government bond yields, compared with a January low of 1.09%.
- Across sectors there was a notable dispersion in credit spread moves; the greatest compression was in bank bonds, aided by further Liability Management Exercises (LME), bond buy-backs, while increased regulatory scrutiny of utilities had a negative impact on the sector. Global consumer company debt also underperformed, reflecting the relative richness of valuations.

Financial sectors

- Financial bonds continued to outperform non-financial sectors, supported by ongoing LME, including a tender offer for subordinated debt from Lloyds Banking Group, and attractive yields.
- Subordinated financial debt gave the highest returns, especially tier 1 and upper tier 2.
- Senior unsecured and senior secured (covered) bonds saw an improvement in performance, with spreads contracting by 0.07% and 0.04%, respectively.

Non-financial sectors

- Performance across non-financial sectors was mixed. Asset backed securities generally performed in line with the wider sterling credit market while utilities underperformed due to a more hawkish regulatory review; water stocks were particularly impacted. Consumer orientated bonds again lagged, reflecting their relatively low credit spread premiums.
- Peripheral European corporate bonds continued their recent buoyancy as sentiment towards peripheral European sovereigns improved further. In contrast, Emerging Market corporates underperformed on fears of a slowdown in China and geopolitical tensions.

Issuance, ratings and maturities

- The growth in issuance seen in the latter part of 2013 continued into 2014, although liquidity conditions remained challenging. The £14bn issuance represented a 25% increase over the comparable period in 2013. The amount of ultra-long dated corporate bond issuance was significantly higher over the quarter.
- Lower rated bonds again outperformed, with BBB rated bonds giving a return of 0.89% in excess of gilts over the quarter; credit spreads contracted by 0.06%. AAA and AA bonds also outperformed government bonds; credit spreads within these rating bands contracted marginally.
- A rated securities recorded the weakest returns; the underperformance was concentrated in March and likely reflected the impact of pension changes outlined in the Budget Statement.
- By maturity, there was a marked underperformance of longer dated credit bonds in March, similarly a consequence of the pension changes. Over the quarter, medium dated bonds gave the best relative returns, with 5 to 7 year bonds seeing a credit spread compression of 0.10%.

Outlook

- 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 2.15% over the quarter.
- The Bank of England (BoE) Monetary Policy Committee (MPC) left policy and quantitative easing unchanged at 0.5% and £375bn, respectively, with no members calling for further stimulus. Forward guidance, based on the unemployment threshold of 7.0% was abandoned and the inflation report highlighted that the MPC are now focussing on a range of variables when determining interest rates.
- The BoE expects the unemployment rate to fall to 6.5% by year end, and aims to close an estimated 1.0% to 1.5% output gap before considering interest rate rises. The market anticipates that the first rate rise will occur in early 2015.
- Fourth quarter UK gross domestic product (GDP) rose by 0.7%, resulting in 2.7% year-on-year growth.
- Issuance over the quarter was broadly balanced across maturities; the Debt Management Office (DMO) announced £128.4bn gilt and £16.5bn T-Bill issuance in 2014/15. This will be split with £32.4bn of short dated gilts (25.2%), £26.9bn of medium dated gilts (21.0%), £33.1bn of long dated gilts (25.8%) and £31.0bn of index linked gilts (24.1%) issued. £106.4bn will be by auction, £17.0bn across four syndications, and £5.0bn by mini-tender.
- The main surprise of the Budget was the change to pension fund legislation. As of April 2015, all defined contribution schemes will be able to gain access to the full pension pot via income drawdown. This will be unlimited and will not be means tested. All drawdowns over and above the 25% tax free cash amount will be taxed at marginal rates of interest. In addition, the government announced that a Department for Work and Pensions consultation will take place to establish whether private sector defined benefit members will continue to have the right to switch to defined contribution and, if so, under which circumstances.
- Medium dated gilts outperformed long and short dated gilts on a risk adjusted basis. The US data was distorted by weather effects, deflationary pressures in Europe led to calls for European Central Bank (ECB) stimulus, and the markets in general were overshadowed by the ongoing crisis in Ukraine.
- Peripheral spreads continued to tighten over the quarter as the hunt for yield continued.

Yield curve moves over the quarter

- Yield curves in the UK flattened between 2 and 10 year maturities and steepened between 10 and 50 years as bond markets rallied over the quarter. The general flight to quality resulted in ten year gilts performing strongly. Shorter dated gilts lagged due to the changes to forward guidance announced by the MPC.
- Issuance in conventional gilts was broadly balanced across maturities.
- At the end of the quarter, the DMO announced the issuance schedule for the upcoming quarter, which will again be spread across maturities with two short, two medium, and one long dated auction, and a long dated syndication in June.
- Over the quarter, conventional gilt yields fell 0.15% at short maturities, 0.33% at medium maturities and 0.14% at long maturities.

Variation of return across the UK market

- Overall, the UK government bond market gave a total return of 2.15% over the quarter, with short dated gilts returning 0.44%, medium dated gilts 2.55%, and long dated gilts 3.43%.

Overseas fixed interest markets

- Yields in core overseas markets fell over the quarter, while peripheral European countries outperformed; gilts generally underperformed in a global context.
- The new Fed chair, Janet Yellen, surprised US bond markets with hawkish rhetoric about the possibility of rate rises early next year.

Outlook

- Economic news suggests continued positive momentum in the UK, although the level of output is still below the previous peak in 2008.
- Headline inflation is low and underlying inflationary pressures appear contained, in particular thanks to global disinflationary pressure and stronger sterling.
- We expect interest rates to remain on hold during 2014, although the BoE 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 year, although we expect some volatility around this trend. Our 31 December 2014 forecasts for 5, 10 and 30 year conventional gilt yields are 2.20%, 3.10% and 3.90% respectively; current yields are 1.97%, 2.73% and 3.51% respectively.

BOND MARKET REVIEW

Index linked bonds

Key points

- Index linked gilts returned 3.22% over the quarter.
- UK consumer price index (CPI) inflation fell to 1.7% in February, its lowest rate in four years. However, retail price index (RPI) inflation was unchanged over the quarter at 2.7%, leaving the 'wedge' between the measures at 1.0%, its highest level since 2011.
- Real yields fell, on average, between 0.15% and 0.22% over the quarter. Longer dated bonds initially underperformed as the market had to digest a further £5bn syndication of the longest dated issue.
- A combination of weaker weather related data from the US, a slowdown in China, and geopolitical tensions in Ukraine were responsible for the fall in yields.
- Oil prices were higher over the quarter as tensions in Ukraine escalated.
- The UK Budget Statement included a decision to allow members of pension schemes the flexibility of not having to buy annuities and the announcement of a consultation regarding the ability of defined benefit scheme members to transfer to defined contribution schemes, sparking some fears that pension fund demand for inflation linked bonds may wane.
- The funding remit for the forthcoming quarter did not include any long dated index linked gilt syndications.
- Breakeven (implied) inflation rates, particularly for shorter dated maturities, initially fell as inflation surprised to the downside. However, they recovered towards the end of the quarter, as speculation of a further widening of the RPI/CPI wedge, resulting from house price inflation and mortgage rate rises, were factored in and prompted buying of shorter dated bonds.

Real yield and breakeven (implied) inflation curve moves

- Real yields initially rose but weaker economic data and political tensions in Ukraine led to a flight to quality as the quarter progressed. Longer dated maturities underperformed, as the market had to digest a further £5bn of the longest dated bond in late January, with the real yield curve steepening by 0.10% over 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, with CPI falling below target for the first time in four years. However the 'wedge' between CPI and RPI widened to 1.0% as house price inflation accelerated and talks of housing bubbles increased. This prompted buying of breakevens towards the end of the quarter.

Variation of return across the UK market

- The real yield differential between 10 and 30 year bonds ended the quarter around 0.10% higher. Ultra-long dated bonds performed particularly badly relative to other maturities as the syndication stock weighed heavily on the market.
- The FTSE Index Linked Gilts All Stocks Index gave a return of 3.22% over the quarter, leaving the twelve month return at -3.79%. Index linked gilts posted positive returns across all maturities.

Overseas and credit index linked market

- Overseas index linked government bonds outperformed, particularly in longer dated maturities, as the market had to place a further £5bn of the 2068 index linked gilt issue. Longer dated US and Canadian index linked government bonds performed particularly well as spreads narrowed by over 0.20%.
- Sterling non-government index linked bonds outperformed index linked gilts by around 0.10% 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. However, the announcement on annuities and the consultation regarding the transfer from defined benefit to defined contribution schemes will create uncertainty. Supply in the forthcoming quarter is significantly lower and biased to sub-30 year issues. With no further ultra-long dated issuance, we would expect a flattening of the real yield curve.
- Long breakeven inflation rates of above 3.50% are now marginally above our 2014 year-end target; we expect them to fall as RPI inflation falls in the first half of 2014.
- Overseas markets offer significantly better value, with real yields between 0.80% and 2.00% higher than the UK.
- Our real yield forecasts for 10 and 30 year index linked gilts at the end of 2014 are 0.30% and 0.60% respectively, significantly higher than current levels.

BOND MARKET REVIEW

Overseas government bonds

Key points

- Extreme winter weather in the US distorted local economic data, although employment data remained moderately firm.
- The US Federal Reserve (Fed) continued to taper their quantitative easing programme and discarded the 6.5% unemployment rate target for base rate rises, opting instead for a wide range of measures, including labour market conditions, inflation expectations and financial markets.
- Chinese growth continued to moderate. Meanwhile a Shanghai solar panel maker became the first Chinese company to default on its corporate bonds, after the government refrained from bailing it out.
- A sell-off across some emerging markets was sparked by fears of a withdrawal of quantitative easing by the Fed and isolated local geopolitical issues. The Turkish Central Bank aggressively raised rates in response to populace-led instability and a weakening currency, and the South Africa Reserve Bank and India’s central bank both unexpectedly raised interest rates.
- Russian military intervention and a controversial referendum resulted in Crimea joining Russia following the ousting of pro-Russian Ukrainian President Viktor Yanukovych.
- Matteo Renzi overturned incumbent Italian Prime Minister Enrico Letta and proposed a stimulus package.

Yield curve moves over the quarter

- Yields fell over the quarter as economic data in the US softened, although poor weather provided little opportunity for firm conclusions to be reached.
- Some signs of US labour market strength later in the period caused bond markets to retrace some of their gains.
- Shorter dated bonds lagged wider moves, causing yield curves to flatten.
- Weak inflation in Europe led to a small outperformance of European bonds.
- At the end of the quarter, 10 year government bond yields in the US, Germany, Japan and the UK were 2.74%, 1.57%, 0.62% and 2.76% respectively.
- Implied inflation rates fell as conventional bonds outperformed their inflation linked counterparts.
- At the end of the quarter, 10 year real yields in the US, core Europe and the UK were 0.59%, 0.13% and -0.25%. Accompanying breakeven inflation rates were 2.14%, 1.44% and 3.01%.

Currency markets

- Over the quarter, sterling was unchanged against the basket of currencies in the indices.
- Gains against the Euro and US Dollar were offset by losses against the Japanese Yen.

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.
- The impact of events in Europe has waned over the past 18 months and no longer dominates market sentiment; the European Central Bank’s Outright Monetary Transactions policy has reduced the immediate threat of countries exiting the Euro-area. However, underlying issues remain unsolved in what is still a diverse monetary union and, although not part of our base case, a return to a cycle of crisis summits remains possible.
- 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 (as described by the BofA Merrill Lynch Global High Yield Index, 100% hedged to sterling) returned 2.89% over the quarter; returns were quite varied over this period (January 0.56%, February 1.91%, March 0.40%).
- The best performing sectors were insurance (4.70%) and media (4.29%). Basic industry (2.14%) and real estate (0.05%) were relative laggards.
- Global new issuance in the quarter was over $101 billion but, due to a low level of issuance across each of the three months, was down 28% on the same period last year. However, this is against 2013's record year where total issuance was over $463 billion. Issuance in the US and Europe accounted for over three quarters of the total year to date, with issuance in Emerging Markets and Other Developed Markets accounting for the remainder.
- The yield on the index ended the quarter 0.31% lower at 5.38%, with the average high yield credit spread at 4.02% above government bond yields. Having tightened 0.21% over the quarter, this level remains well above the all-time low of 2.37%, set in May 2007.

Regions

- The US and Canada region returned 3.01% for the quarter. Credit spreads tightened by 0.22% while underlying government yields were 0.11% lower. Most of the quarter's spread tightening was produced in February.
- Europe returned 3.16% for the quarter and was the outperforming region. Despite shorter duration than the US and Canada, the spread tightening and underlying government yield moves were greater in magnitude, at -0.48% and -0.14%, respectively.
- Emerging Markets was the weakest performing region, returning 1.85% over the quarter. This region produced -0.83% returns in January, due to a combination of outflows and pressure on local currencies.

Monthly performance

- January was a volatile month, with initial gains being pared back in the final week. The market finished 2013 with a strong tone and this trend continued in the opening weeks of the new year, until the market became unsettled by the combination of middling US economic data, weaker than expected Chinese manufacturing PMI data and the reoccurrence of strains across the Emerging Markets. Outflows from the asset class were witnessed in the final stages of the month, with the market giving back over half of its cumulative month to date gains. The opposing effects of lower government yields and wider credit spreads were the main drivers of returns across ratings and geographies.
- After the first two days of the month, February returned consistently positive daily returns. Risk assets advanced on comments from US Federal Reserve (Fed) Chair Janet Yellen, who advocated that monetary stimulus would be scaled back in "measured steps". Yellen's comments were interpreted by markets as a continuation of her predecessor's supportive policies. While credit spreads tightened at a robust pace, the US weather-related weakness affecting economic data and Emerging Market concerns helped to keep government bond yields relativity unchanged on the month.
- Unlike February, the Global High Yield market lacked any strong sense of direction in March. This was due to a variety of conflicting factors. The continuation of concerns over Chinese growth and the geopolitical tensions in Ukraine were offset by somewhat limited net new supply of bonds and continual investor flows into the asset class. Fed commentary caused a shift in interest rate expectations, pushing underlying government bond yields higher, with the market only recovering to a flat position after the first three weeks. The cumulative effect of income returns eventually provided the small positive return witnessed in March.

Ratings & maturities

- For the quarter, the various credit rating baskets performed relatively in line with one another. BB, B and CCC and lower rated bonds returned 2.98%, 2.70% and 3.04% respectively for the quarter. Yields at the end of the quarter stood at 4.30%, 5.53% and 9.06%, respectively.
- Returns for the quarter were better at longer maturities due to a combination of spread compression and lower underlying government bond yields. Returns were 1.51% for 0 to 3 years, 2.13% for 3 to 5 years, 2.79% for 5 to 7 years, 4.04% for 7 to 10 years and 6.12% for over 10 year bonds.

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 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 moderate level of new issuance is expected for 2014.

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 December, economic news in the US, UK and eurozone has been close to our expectations, although news from China has been somewhat weaker. 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 Advanced 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 0.7% in the final quarter of 2013, supported by rising investment and exports. More recent survey indicators suggest that positive momentum has continued into the first quarter. 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. We expect growth in 2014 will be driven mainly by domestic demand, rather than net trade, where the gains from sterling's post crisis devaluation have been somewhat disappointing to date.
- Following the impact of severe winter weather, we expect US growth to pick up during 2014, thanks to a smaller fiscal drag and supportive monetary policy. 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 we have reduced our GDP growth forecasts from 7.5% to 7.0%.
- The impact of the eurozone crisis on market sentiment has waned over the past 18 months, as the European Central Bank's Outright Monetary Transactions policy has reduced the immediate threat of countries exiting the Euro-area. Underlying issues remain unsolved in what is still a diverse monetary union, 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 1.7% in February, in part thanks to the recent rise in sterling. Inflation should fall further in the near term, given energy base effects. However, our base case assumes that inflation will rise towards the 2% target by year end, as the improvement in labour market conditions feeds into stronger wage growth, and the effect of a stronger sterling begins to fade.
- In February, the Bank of England Monetary Policy Committee announced a revision to their forward guidance on interest rates, with a focus on a broader measure of economic "slack" replacing a particular focus on the headline unemployment rate. They also signalled that when the bank rate does begin to rise, it expected that the appropriate path would be gradual, and even when the economy had returned to normal levels of capacity, the appropriate rate was likely to be materially below the 5% pre-crisis average.
- 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 over the past year, investors are still paying a high price for the prospect of low real returns. We 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.

SPECIAL TOPIC

The impact of the recent budget statement on gilt and sterling credit markets

While there were a number of other key points to the 2014 Budget Statement, covering growth, business, welfare, betting, alcohol etc., there were a number of announcements that should help savers. Notably, the cash and stocks ISA limits were merged and the overall limit increased, and the 10p starting rate for income from savings was abolished. Additionally, the government announced the introduction of pensioner bonds, available to over-65s and paying around 4% per annum interest, and an increase in the maximum holding in premium bonds. While these announcements were all something of a surprise, such small changes are not unusual. However, the announcements in relation to pension reform were a much greater surprise, and of great significance.

There were some immediate changes to the pension system, such as an increase in the amount that can be taken out as a lump sum, and an increase on the limit on capped drawdowns. However, the main change announced was that, for pensioners emerging from defined contribution (DC) scheme arrangements, there will no longer be any obligation to use their pension “pot” to buy an annuity. Rather, pensioners will be able to take their pension savings how and when they want, subject to their marginal rate of income tax in a year. Alongside this, the government consultation will examine the ability of members of private sector defined benefit (DB) pension schemes to transfer to DC arrangements; from there, pensioners could use the newly announced flexibility around annuities to decide whether to buy an annuity or remain invested.

Long dated bonds (gilts and, to a greater extent, corporate bonds) are typically bought by insurers who sell annuities as they match the liabilities taken on by them. Given the changes announced (no obligation on retirees to purchase annuities), demand from the insurers for longer dated bonds is likely to be less, which may put some upward pressure on gilt yields and long dated credit spreads.

As with any Budget Statement, there was an announcement with regards to the forecast amount of borrowing that the government will carry out via the gilt market over the next financial year. The forecast amount was around £20bn lower than expectations. The reasons for this shortfall were an improved UK budget deficit, as well as the introduction of pensioner bonds and the increase in the investment limit on premium bonds as means of raising finances away from the gilt market. Lower issuance normally (in the face of constant demand) means lower yields. Given the announcement regarding annuities, the impact of which would be to push longer yields higher, the immediate impact of the issuance forecast was restricted to shorter maturities, where government bond yields rose less. It would be reasonable to expect that this steepening of the yield curve, as longer dated bonds fall further out of favour, will continue.

The proposed flexibility around annuities, and the matter of whether members of private sector DB pension schemes should be allowed to transfer to DC schemes, are under government consultation. The consultation will last until mid-2014, with no decision on their implementation expected until at least September, and a separate act of parliament required to implement changes. It is impossible to predict how investors might react to the reforms, if implemented. However, a number of investor reactions could reasonably be expected. Demand for annuities, the market which has been widely criticised as being unfairly restrictive, could be expected to fall. Some estimates have suggested that the demand for annuities will fall by around 75%. Investors who, given the new flexibility, choose not to purchase an annuity are likely to look at personal pension investments that offer higher levels of income. Moreover, as opposed to being forcibly led to products based on longer maturity fixed income investments, investors with choice would be likely to consider a wide range of assets, including shorter maturity and higher yielding fixed income, cash, equity and property investments. A number of examples of relevant funds are managed by Royal London Asset Management (shown in the table below).

Members of private sector DB schemes could be expected to consider switching to DC arrangements, if available, in order to gain flexibility in relation to their pension savings. Those pensioners, along with all other DC pensioners, would then have the choice of purchasing an annuity or investing with more choice. Any decision on whether to invest in an annuity would be dependent on the rate on offer at the time, which would depend on longer dated bond yields. While, on the face of it, the reforms could be looked upon as being negative for the market in long-dated bonds, one could look more favourably upon them in that they could open up a new source of demand for annuities (and hence long-dated bonds).

Markets are driven by investor demand and, should the demand for longer-dated bonds be affected by pensioners making investment choices of their own, the market in those assets would be impacted. Ultimately, should demand for those assets dry up, there would be less opportunity for bond issuers (the government and companies) to access funding by issuing bonds at those maturities.

Fund name	Benchmark	Fund size
RL Corporate Bond Fund	iBoxx Sterling Non-Gilts All Maturities Index	£488m
RL Sterling Extra High Yield Bond Fund	N/A*	£893m
RL UK Equity Income Bond Fund	FTSE All Share Index	£1,260m
RL Global High Yield Bond Fund	BoAML BB-B Global Non-Financial High Yield Constrained Index	£177m

* Fund is managed with a performance objective of 1.25 times the gross redemption yield of the FTSE Actuaries British Government 15 Year index.

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 portfolios.

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.

Fixed Interest team changes

Following the acquisition of The Co-op Asset Management, we welcome Richard Nelson to RLAM's Fixed Income Team. Richard manages the two recently launched fixed income sustainable funds – Sustainable Managed Growth and Sustainable Managed Income - and has recently taken over managing the CIS Corporate Bond Income Trust. Richard joined The Co-operative as a trainee actuary in 1994, before moving into Asset Management in 1997 where he helped run the cash and treasury function from 1999. He has been managing gilts since 2000 and corporate bonds since 2005 and currently manages the life fund portfolios and the bond portfolios of the Sustainable Diversified and Sustainable World Trusts. Richard qualified as an actuary in 2003 and holds a degree in Mathematics & Statistics from Exeter University.

Distribution team changes

We welcome Emmanuel Archampong to RLAM as a Business Development Manager focusing on the insurance investment business. Emmanuel previously worked at Barrie and Hibbert where he was an Associate Director responsible for developing capital models for insurance companies in the Nordics and Pension schemes in the UK. Prior to this, Emmanuel worked at JP Morgan Asset Management, providing investment advisory solutions for insurance companies across Europe. Emmanuel has a BSc in Actuarial Science, a MSc in Risk Management and is currently pursuing an MBA at Warwick Business School.

RLAM

Your dedicated contact

James Stoddart
Client Account Director

t: 020 7506 6619
f: 020 7506 6784
e: james.stoddart@rlam.co.uk

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

Your Client Account Management Team

Victoria Muir
Head of Client Account Management

t: 020 7506 6758
f: 020 7506 6784
e: victoria.muir@rlam.co.uk

Lucy Bramwell
Client Account Manager

t: 020 7506 6537
f: 020 7506 6784
e: lucy.bramwell@rlam.co.uk

Fraser Chisholm
Client Account Manager

t: 020 7506 6591
f: 020 7506 6784
e: fraser.chisholm@rlam.co.uk

Georgina Montalvo
Client Account Manager

t: 020 7506 6563
f: 020 7506 6784
e: georgina.montalvo@rlam.co.uk

Lorraine Meighan
Client Account Manager

t: 020 7506 6736
f: 020 7506 6784
e: lorraine.meighan@rlam.co.uk

Daniel Norsa Scott
Client Account Manager

t: 020 7506 6602
f: 020 7506 6784
e: daniel.norsascott@rlam.co.uk

George Barbett
Client Account Assistant

t: 020 7506 6500
f: 020 7506 6784
e: george.barbett@rlam.co.uk

Mark Elbourne
Client Account Assistant

t: 020 7506 6671
f: 020 7506 6784
e: mark.elbourne@rlam.co.uk

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.

Portfolio Valuation

As at 31 March 2014

Dorset County Pension Fund

	Holding	Asset Description	Market Price (Bid £)	Book Cost Capital (£)	Market Cap. Value (£)	Accrued Inc. Value (£)	Market Value (£)	Days Accrued	Market Value %
Funds Held									
	110,730,831	RLPPC Over 5 Year Corp Bond Pen Fd	1.78206	121,280,190.50	197,328,984.73	0.00	197,328,984.73	0	100.0
			Funds Held total	**121,280,190.50**	**197,328,984.73**	**0.00**	**197,328,984.73**		**100.0**
			Grand total	**121,280,190.50**	**197,328,984.73**	**0.00**	**197,328,984.73**		**100.0**

Trading Statement

For period 01 January 2014 to 31 March 2014

Dorset County Pension Fund

	Trade Date	Transaction Type	Nominal	Security	Price (£)	Book Cost (£)
Acquisitions						
Funds Held						
	08 Jan 2014	Acquisition Rebate	82,399.48	RLPPC Over 5 Year Corp Bond Pen Fd	1.76	144,943.16
					Funds Held total	**144,943.16**
					Acquisitions total	**144,943.16**