# DORSET COUNTY PENSION FUND

## Quarterly Report 30 June 2014

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# YOUR PORTFOLIO

## Portfolio performance objective

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

## Portfolio asset allocation and benchmark ranges

| Fund class and benchmark index | Actual allocation (%) |
|---|---|
| **RLPPC Over Five Year Corporate Bond Fund**<br>Benchmark: iBoxx Sterling Non-Gilt Over 5 Year Index | 100.0 |

## Portfolio value

| | Total (£m) |
|---|---|
| **30 June 2014** | **203.18** |
| 31 March 2014 | 197.33 |
| Change over quarter | 5.85 |
| Net cash inflow (outflow) | 0.00 |

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# EXECUTIVE SUMMARY

## Performance

- The fund gave a gross return of 2.96% over the quarter, compared with a benchmark return of 2.64%. This brings performance for the first half of 2014 to 6.79% versus the benchmark of 5.68%.

## The economy and bond markets

- The UK economy grew by 0.8% in quarter one, with recent business surveys suggesting the positive momentum has continued. UK consumer price index (CPI) inflation fell to 1.5% year-on-year in May. There are some signs of slowdown in housing market activity, while Bank of England (BoE) officials have given mixed messages about future base rate rises.
- Growth in the US slowed dramatically in quarter one of 2014 (-2.9% annualised); we expect growth to rebound in quarter two. The US Federal Reserve (Fed) kept interest rates unchanged, continued to taper its quantitative easing programme and reiterated its commitment to keeping interest rates at their current level for some time. The eurozone economy grew by 0.2% in quarter one, less than expected. Business surveys suggest that growth has continued in quarter two, albeit at a modest pace. Confidence in peripheral bonds has continued to improve. However, persistently low inflation and the possibility of outright deflation prompted the European Central Bank (ECB) to again reduce its main refinancing rate and signal its intention to keep rates low. In China, growth slowed to 7.4% year-on-year in quarter one while survey data suggests there has been some stabilisation in growth rates in quarter two. In Japan, quarter one GDP grew by 1.6% quarter-on-quarter, but looks to have slowed sharply in quarter two.
- Conventional gilts returned 1.08% over the quarter, with short dated gilts underperforming long and medium dated gilts as the gilt market brought forward rate rise expectations. Real yields also rose at the shorter end of the market but pension fund demand caused longer real yields to fall. Index linked gilts returned 0.97% over the quarter. Breakeven (implied) inflation rates, particularly for shorter dated maturities, fell as inflation surprised to the downside. Sterling investment grade credit bonds returned 2.40%, outperforming government bonds. Subordinated financial bonds remained the best performing area, while supranational debt and consumer orientated bonds underperformed. Credit spreads narrowed over the quarter, ending the period 1.05% above government bond yields. Global high yield bonds returned 2.91%.

## Investment outlook

- Against expectations, government bond yields have fallen since the beginning of the year. We expect yields to move higher from current levels, as US economic data improves and we move closer to rate hikes from both the Fed and BoE. However, 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. We expect returns from investment grade corporate bonds to exceed government bonds by at least 1.20% p.a. over the next three years.

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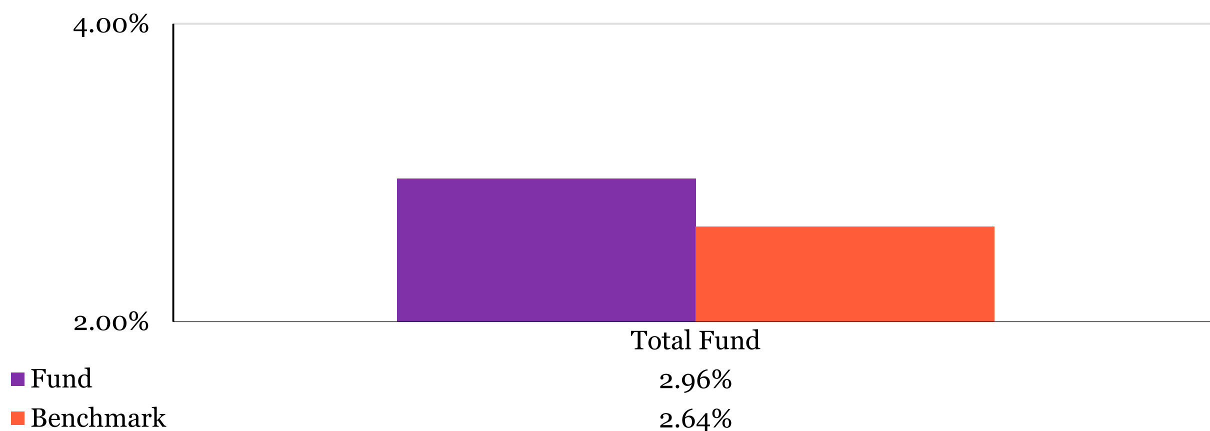
## FUND PERFORMANCE

The table below shows the gross performance of the portfolio and the benchmark for the periods ending 30 June 2014:

### Performance

| | Fund (%) | Benchmark (%) | Relative (%) |
|---|---|---|---|
| **Q2 2014** | **2.96** | **2.64** | **0.33** |
| Year to date | 6.79 | 5.68 | 1.12 |
| Rolling 12 months | 10.68 | 8.22 | 2.46 |
| Three years p.a. | 14.27 | 13.90 | 0.37 |
| Five years p.a. | 14.85 | 10.40 | 4.45 |
| Since inception 02.07.07 p.a. | 9.45 | 9.79 | -0.34 |

### Quarterly performance




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

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# RLPPC UK OVER 5 YEAR CORPORATE BOND FUND

## Quarter 2 2014

### Asset split

| | Fund (%) | Benchmark[1] (%) |
|---|---|---|
| Conventional credit bonds[2] | 99.7 | 98.8 |
| 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 | 1.2 |
| Foreign index linked sovereign | 0.0 | 0.0 |
| Derivatives | 0.0 | 0.0 |

### Fund data

| | Fund | Benchmark[1] |
|---|---|---|
| Duration | 9.8 years | 9.9 years |
| Gross redemption yield[3] | 4.50% | 4.01% |
| No. of stocks | 373 | 720 |
| Fund size | £204.3m | - |

*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 (%) |
|---|---|---|---|
| **Q2 2014** | **2.95** | **2.64** | **0.31** |
| Year to date | 6.69 | 5.68 | 1.01 |
| Rolling 12 months | 10.52 | 8.22 | 2.30 |
| Since inception p.a. (02.07.2012)[2] | 10.20 | 7.49 | 2.71 |

*[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 0.80% 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.

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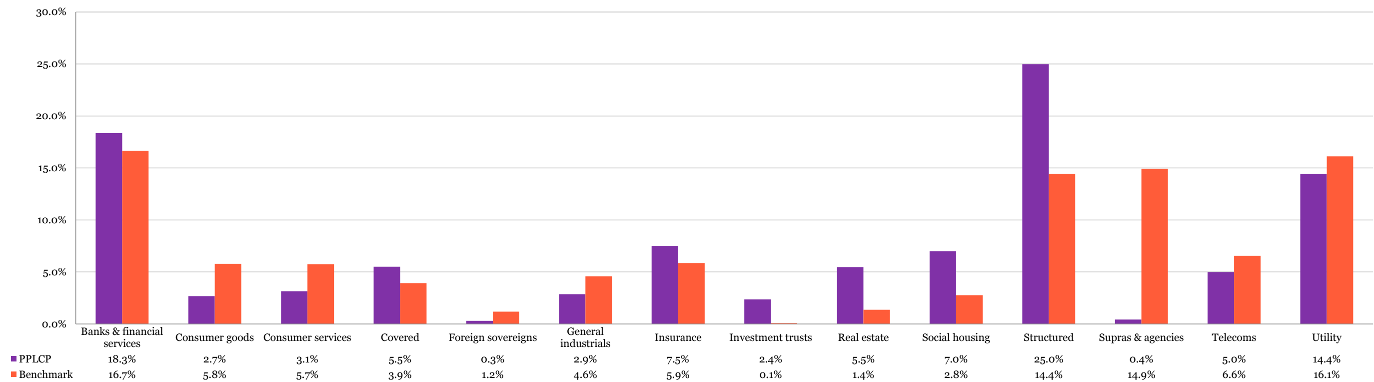
# RLPPC UK OVER 5 YEAR CORPORATE BOND FUND

## Quarter 2 2014

### Sector breakdown




***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 significant underweight position in supranational bonds. | Supranational bonds lagged the overall sterling credit market, returning 1.45% over the quarter versus 2.04% for the asset class as a whole. | The underweight exposure to supranational debt was a positive contributor to relative performance. |
| We continued to prefer a combination of covered bank bonds and subordinated bank debt to senior bonds. | The bias towards subordinated financial bonds was increased through several new issue purchases, including from **Standard Chartered**, **Rabobank** and **L&G**. | Demand for subordinated financial debt remained strong, supported by ongoing buy-backs.<br><br>Following the impact of pension reforms outlined in the Budget, insurance bonds rebounded and reversed the poor performance recorded in quarter one to be the strongest performing sector in quarter two.<br><br>Covered bonds outperformed senior unsecured financial bonds by 1.05%. | The underweight exposure to senior unsecured financials and bias to subordinated debt and covered bonds was a key positive driver of performance. |
| We thought that high profile consumer orientated bonds were unattractively priced relative to more non-cyclical corporate debt sectors. | We maintained an underweight exposure to such bonds. | Highly rated consumer bonds underperformed non-cyclical sectors, reflecting their low credit spread premium and reduced scope for credit spread compression. Outside of financials, utilities and telecoms were the strongest performers, returning 3.01% and 3.08% respectively. | 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 underperformed the wider sterling credit market. | The exposure to secured and ABS bonds was a marginal drag on performance in the quarter. |

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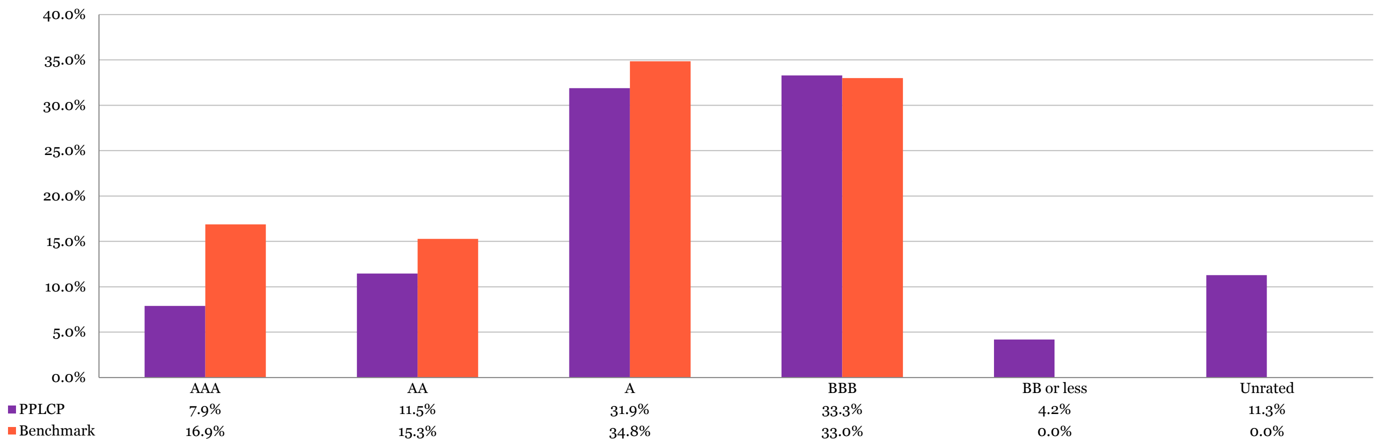
# RLPPC OVER 5 YEAR CORPORATE BOND FUND

## Quarter 2 2014

### Rating breakdown




***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 believed that lower rated bonds offered better value than AAA/AA rated securities. | There was no material change in the credit rating profile of the portfolio.<br><br>The overweight exposure to lower rated bonds was increased marginally, reflecting participation in several subordinated financial deals. | BBB rated bonds posted the strongest returns over the quarter, returning 2.0% in excess of gilts, while higher rated bonds lagged.<br><br>Both AAA and AA rated bonds underperformed, returning 0.69% and 0.50% respectively, on a duration adjusted basis, while A rated bond returns broadly matched the wider credit market. | The credit rating profile of the portfolio was beneficial to fund performance. |

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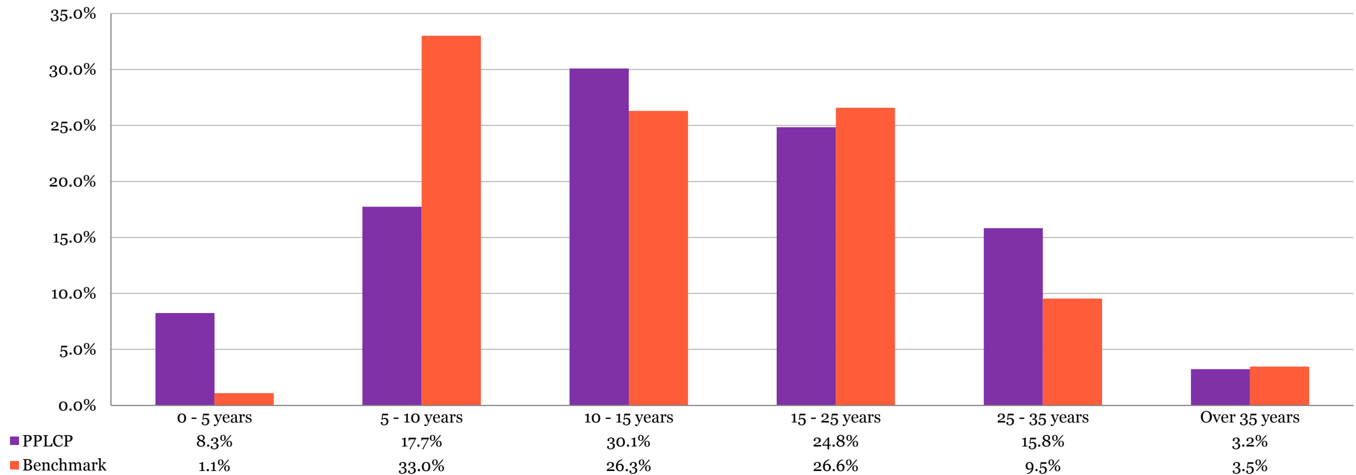
# RLPPC UK OVER 5 YEAR CORPORATE BOND FUND

## Quarter 2 2014

### Maturity profile




| | 0 - 5 years | 5 - 10 years | 10 - 15 years | 15 - 25 years | 25 - 35 years | Over 35 years |
|---|---|---|---|---|---|---|
| PPLCP | 8.3% | 17.7% | 30.1% | 24.8% | 15.8% | 3.2% |
| Benchmark | 1.1% | 33.0% | 26.3% | 26.6% | 9.5% | 3.5% |

***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 |
|---|---|---|---|
| Following a sharp fall in government bond yields in quarter one, we expected a modest increase over the remainder of the year. | The overall bias of the portfolio was to be short duration throughout the quarter. | Government bond yields were volatile, initially falling following a dovish inflation report, before rising near the end of the quarter as a hawkish Mansion House speech brought forward base rate rise expectations. | The short duration position maintained over the quarter was marginally detrimental to fund performance. |
| We believed that credit spreads were most attractive at medium maturities. | We maintained an overweight exposure to medium dated credit bonds and further reduced the exposure to short dated bonds. | As UK economic data continued to improve and the Bank of England Governor raised the prospect of an earlier rate rise, short dated bonds underperformed while medium and long dated bonds posted strong absolute and relative returns. | Yield curve positioning was marginally beneficial to fund performance. |

# RLPPC UK OVER 5 YEAR CORPORATE BOND FUND

## Quarter 2 2014

### Ten largest holdings

| | Rating | Weighting (%) |
|---|---|---|
| Annington Finance 0% 2022 | AAA | 1.5% |
| Finance for Residence Social Housing 8.369% 2058 | A- | 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 | 0.9% |
| GE Capital 6.25% 2038 | AA+ | 0.9% |
| EDF Energy 6% 2114 | A+ | 0.9% |
| Nationwide Building Society 5.625% 2026 | AAA | 0.9% |
| Annes Gate Property 5.661% 2031 | bbb+* | 0.8% |
| **Total** | | **11.1%** |

***Source:*** *rlam. Figures in the table above exclude derivatives where held.*Lower case rating denotes a Royal London internal rating.*

# RLPPC UK OVER 5 YEAR CORPORATE BOND FUND

## Quarter 2 2014

### Fund activity

- New issuance activity remained healthy in the quarter and, reflecting an improvement in investor sentiment towards the financial sectors, was firmly biased towards these bonds in contrast to previous years. In the banking sector, the fund added to its exposure to **Rabobank** and **Standard Chartered** through the participation in new subordinated offers, and established a new position in **BPCE**, the second largest banking group in France, through a debut £750m lower tier 2 transaction. BPCE activities cover savings and investment solutions, cash management services, financing solutions, insurance, and wholesale banking services. The group operates on a cooperative banking model. The bonds were issued at a credit spread over UK government bonds of 2.15%, being rated BBB+ by S&P. We believed that this represented good value in the context of portfolio diversification and the high relative yield being offered. Since issue, the bonds have tightened to a credit spread of approximately 2%.
- Within the insurance sector, and following recent issuance from UK insurers, Prudential, Scottish Widows and Standard Life during the last twelve month, **Legal and General** issued a subordinated lower tier 2 bond at 1.17% above the benchmark gilt. While the bonds were well oversubscribed, the performance in the secondary market was subdued.
- In the secondary market we added to **Grosvenor Finance** and **Telereal**. The former is a bond secured against a portfolio of high quality West London commercial property, whilst the latter is secured against property rented by BT. Both are examples of embedding greater security into the portfolio without sacrificing yield.
- The fund sold several positions to finance the new issue purchases. We reduced exposure to **Imperial Tobacco**, **Directv**, **Fonterra** and **Co-op Wholesale Society**. The fund retains a small exposure to **Co-op Group** (0.20% of total assets); we believe that this position is appropriate given our analysis of the credit fundamentals and the yield at which these bonds trade.

### Key views in your portfolio

- A significant underweight in government bonds, as we expect credit bonds to outperform.
- Duration marginally shorter than that of the benchmark, as we expect underlying gilt yields to rise in the second half of 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.
- Targeted exposure to higher yielding bonds through investment in the Royal London Sterling Extra Yield Bond Fund.

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# ECONOMIC REVIEW

## Key points

- After a weak start to the year, recent evidence suggests a pick-up in global growth rates, driven by the US and China.
- In June, the European Central Bank (ECB) reduced its main refinancing rate to another record low of 0.15% and signalled its intention to keep rates low.
- The Governor of the Bank of England (BoE) signalled the possibility of a rise in interest rates before the end of 2014, although other BoE officials gave subsequent contradictory messages.

## Growth

- Global GDP growth slowed at the start of the year, primarily as a result of a sharp drop in activity in the US and slower growth in China and some other Emerging Markets. More recent survey evidence suggests that there has been a marked improvement during quarter two, particularly in the US, while growing unrest in Iraq does not appear to have had a significant impact on financial markets to date.
- The US economy grew by 1.9% in 2013, with strong momentum through the second half of the year. A budget deal in late 2013 eased the programme of government spending cuts and tax rises planned for 2014. Growth slowed dramatically in quarter one of 2014 (-2.9% annualised), as a result of severe winter weather and a fall in healthcare spending. However, we expect growth to rebound in quarter two, and the underlying momentum in the economy appears similar to our expectations in March, although we have downgraded full year GDP growth to below 2%. An easing in fiscal drag is the major reason for expecting a pick-up in growth, while ongoing deleveraging and rising asset prices have boosted household net worth.
- The Eurozone economy grew by 0.2% in quarter one, somewhat less than expected. Given trade links, the weather related weakness in the US economy may have been a factor. Business surveys suggest that growth has continued in quarter two, albeit at a modest pace. Peripheral countries have made further progress in improving their external positions, with the latest data showing current account surpluses in almost all these countries. Confidence in peripheral bonds has continued to improve, with yields falling towards post crisis lows. However, persistently low inflation and the possibility of outright deflation in the eurozone remain a downside risk to the global and UK outlook.
- The UK economy grew by 0.8% in quarter one, with consumer spending and investment the main drivers. The most recent business surveys (including the PMIs) suggest that positive momentum has continued into quarter two, with GDP growth if anything a little stronger. Surveys and official estimates suggest that business investment has now begun to recover more convincingly. We have upgraded our base case 2014 GDP growth forecasts to 3%, from 2.7%. There are some signs of slowdown in housing market activity, as lenders adapt to more robust mortgage approval regulations.
- In China, growth slowed to 7.4% year-on-year in quarter one, as the effect of earlier policy tightening measures continued to slow the rate of expansion. Survey data suggest there has been some stabilisation in growth rates in quarter two and we continue to expect the economy to grow by an average of 7% during 2014. In Japan, quarter one GDP grew by 1.6% quarter-on-quarter, as demand rose ahead of the April VAT hike. However, the economy looks to have slowed sharply in quarter two.

## Inflation

- Inflation, as measured by the UK CPI, fell to 1.5% year-on-year in May, in part reflecting an intensification of the latest supermarket price war. The rise in sterling has also helped contain import costs. Survey-based measures of inflation expectations also fell during the quarter, while wage pressures remained subdued.

## Interest rates

- In June, the ECB reduced its main refinancing rate to another record low of 0.15% and signalled its intention to keep rates low. The US Federal Reserve (Fed) kept its key benchmark rate at 0.25% and continued to reduce the pace of its quantitative easing programme. The Chair of the Fed, Janet Yellen, reiterated the commitment to keeping interest rates at their current level for some time.
- In the UK, the Monetary Policy Committee (MPC) kept the bank rate at 0.5%. However, a speech by Governor Mark Carney in June signalled the possibility of a rise in interest rates before the end of 2014. The MPC maintained its guidance that it would take into account a range of variables when setting policy, with a particular focus on wage pressures. They signalled that any rise in interest rates would be gradual and to a level materially below pre-crisis norms.

## 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.

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# BOND MARKET REVIEW

## Investment grade: financial & corporate bonds

### Key points

- Sterling investment grade credit bonds returned 2.04%, continuing the asset class's strong run year to date.
- Credit spreads, the average yield differential between the gilts and sterling investment grade credit bonds, fell to 1.05%; credit spreads ended the quarter lower across all sectors.
- Subordinated financial bonds performed well while senior bank debt underperformed; outside of financial sectors, utilities and telecoms outperformed with asset backed securities (ABS) and consumer sectors lagging.

### Credit spreads

- Sterling investment grade credit bonds outperformed UK government bonds by 1.24%, duration adjusted.
- Credit spreads narrowed, with the average yield differential contracting 0.13% and ending the period 1.05% above government bond yields.
- All non-government sectors saw a narrowing of credit spreads. Subordinated bank debt saw the greatest credit compression, aided by further tender offers for tier 1 debt (e.g. Barclays). The decrease was more modest for consumer, supranational and ABS sectors.
- Credit spreads remain wider than levels consistent with the long run corporate default rate.

### Financial sectors

- Financial bonds continued to outperform those in non-financial sectors, with subordinated financial debt, especially tier 1 and upper tier 2 bonds, recording the highest absolute returns and relative returns versus gilts over the quarter.
- Senior unsecured bank debt underperformed senior secured (covered) bonds, reflecting the fairly narrow differential that prevailed at the end of the first quarter; spreads contracted by 0.07% and 0.12%, respectively.
- The insurance sector bounced back strongly after quarter one's weakness, which had been caused by the pension changes announced in March's Budget Statement. The sector returned 2.92% over quarter two, with spreads contracting 0.20%.

### Non-financial sectors

- All non-government sectors outperformed government bonds over the quarter.
- Telecoms and utility debt outperformed, partly reflecting the improved sentiment towards the sovereign and corporate debt of Italy, Ireland and Spain (higher weightings in utility and telecom sectors).
- Consumer orientated bonds once again lagged, reflecting their relatively low credit spread premiums, while ABS also underperformed the wider sterling credit market.
- Peripheral European corporate bonds continued their recent buoyancy as sentiment towards peripheral Europe improved further following rating agency upgrades of several sovereigns, including those of Spain, Greece, Portugal and Ireland.

### Issuance, ratings and maturities

- New bond issuance remained strong. Although almost 20% lower compared to the first quarter of the year, the £11.4bn issued over the second quarter represented an over 30% increase over the comparable period in 2013. In contrast to previous years, financial issuance dominated, reflecting improved sentiment from investors as capital increases in the sector supported spreads. By maturity, expectations of a sharp drop in long dated issuance, reflecting the impact of pension changes outlined in March's Budget Statement, proved premature as issuance remained strong.
- Lower rated bonds again outperformed, with BBB rated bonds giving a return of 1.97% in excess of gilts over the quarter; credit spreads contracted by 0.22%. AAA and AA rated bonds also outperformed government bonds although credit spread compression was less marked at 0.13% and 0.08%, respectively. A rated securities saw an improvement in relative performance, following a poor first quarter in the wake of pension changes outlined in March's Budget Statement.
- By maturity, the lowest returns were recorded by the shortest dated bonds, with medium and longer maturity bonds outperforming the broader sterling credit market. Over the quarter, longer dated bonds gave the best relative returns, while credit spread compression was greatest in 5 to 7 year maturities, falling 0.48%.

### Outlook

- We continue to believe that the pricing of credit bonds undervalues the asset class, relative to government securities.
- We expect that investment grade credit bonds will outperform UK government securities by approximately 1.20% p.a. over the next three years.

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# BOND MARKET REVIEW

## Conventional government bonds

### Key points

- Conventional gilts returned 1.08% over the quarter.
- The Bank of England (BoE) Monetary Policy Committee (MPC) left policy and quantitative easing unchanged at 0.5% and £375bn, respectively, however the minutes suggested a greater debate about whether to raise interest rates.
- The BoE reiterated the view that they would need to see signs that the output gap of 1.0% to 1.5% was eroding before considering interest rate rises. This would likely be witnessed by an increase in wages. The market anticipated that the first rate rise would occur in early 2015. However, in his Mansion House speech, Mark Carney suggested that rates may need to rise sooner than this, causing the market to price in the probability that they may raise rates in quarter four 2014.
- Conventional gilt issuance over the quarter was broadly balanced across maturities, and index linked issuance biased more towards longer dated maturities. The Debt Management Office (DMO) syndicated a new 3.5% coupon 2045 maturity gilt. At syndication, this was the highest yielding gilt on the curve at 3.45%. The syndication went well with a book of over £15bn for a £5bn issue. The market will now turn its attention to an index linked gilt syndication in July, which is likely to have a 2058 maturity.
- The European Central Bank (ECB) cut interest rates over the quarter to stave off the threat of disinflation becoming deflation. The benchmark rate was cut to 0.15% and the deposit rate to -0.10%. In addition, the ECB announced that a four year targeted Long Term Refinancing Operation (LTRO) programme would begin in September, and ECB president Mario Draghi hinted that the central bank still stands ready to purchase assets if the need arises.
- Short dated gilts underperformed long and medium dated gilts on a risk adjusted basis as the gilt market brought forward rate rise expectations. The ECB rate cut and the distorted first quarter US GDP numbers led to an outperformance of overseas markets. The situation in Ukraine weighed less on markets, but the issues in Iraq took over and supported core bond markets.

### Yield curves move over the quarter

- Yield curves in the UK flattened between 2 and 10 year maturities, and also between 10 and 50 years, as the bond market re-assessed its rate call over the quarter. The move resulted in five year gilts performing poorly. Medium dated gilts were relatively unchanged and long dated gilts performed well, as the market continued to believe that the terminal rate would remain low.
- Issuance in conventional gilts was broadly balanced across maturities with a long dated syndication.

### Variation of return across the UK market

- Overall, the UK government bond market gave a total return of 1.08% over the quarter, with short dated gilts returning -0.01%, medium dated gilts 0.85%, and long dated gilts 2.32%.

### Overseas fixed interest markets

- Yields in core overseas markets fell over the quarter, while peripheral Euro area countries outperformed; gilts generally underperformed, in a global context.
- The ongoing concerns over eurozone deflation, and the potential for some form of quantitative easing, saw the yields of German government bonds move towards their all-time lows.

### 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 a stronger sterling.
- We expect interest rates to remain on hold for the remainder of 2014, with the BoE using macro prudential tools to cool momentum in the housing market. The eventual 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 2.40%, 3.20% and 3.90% respectively; current yields are 2.03%, 2.67% and 3.42%, respectively.

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# BOND MARKET REVIEW

## Index linked bonds

### Key points

- Index linked gilts returned 0.97% over the quarter.
- UK consumer price index (CPI) inflation fell to 1.5% in May, its lowest rate in nearly five years, while retail price index (RPI) inflation fell to 2.4%, leaving the 'wedge' between the measures at 0.9%, a disappointment to many investors who had believed the differential would widen as house price inflation gathered momentum.
- Real yields rose at the shorter end of the market prompted by expectations of base rates rising sooner than expected. Longer real yields fell by around 0.05% as a consequence of strong pension fund demand.
- Weaker US data, easier European monetary policy and a heightening of geopolitical tensions led to government bond yields falling, globally, with the UK underperforming both European and US bonds.
- Oil prices rose over the quarter as tensions in Iraq escalated.
- The funding remit for the forthcoming quarter will begin in July with a syndication of a long dated index linked bonds with either a 30 or 45 year maturity.
- Breakeven (implied) inflation rates, particularly for shorter dated maturities, fell as inflation surprised to the downside.

### Real yield and breakeven (implied) inflation curve moves

- Real yields initially fell across the curve as weaker global data and a dovish inflation report led to the prospect of a rate rise in 2014 diminishing. Towards the end of the quarter, stronger data and a Mansion House speech by the governor of the Bank of England, which raised the possibility of an earlier base rate rise, led yields to retrace back to levels seen at the beginning of the quarter. The exception was the five year sector where yields ended the quarter 0.20% higher.
- Breakeven inflation rates, particularly in the 5 to 10 year sector, fell over the quarter as inflation undershot forecasts, with CPI falling to its lowest level in nearly 5 years despite oil prices rising. The 'wedge' between CPI and RPI unexpectedly remained at 0.9% as a booming housing market was not reflected in a higher RPI rate of inflation.

### Variation of return across the UK market

- The real yield differential between 10 and 30 year bonds fell by around 0.06%. Ultra-long dated index linked gilts performed well relative to other maturities as supply was limited and demand from pension funds persisted.
- The FTSE Index Linked Gilts All Stocks Index gave a return of 0.97% over the quarter, leaving the twelve month return at 3.90%. Index linked gilts posted positive returns across all maturities with the exception of sub-5 year bonds. The best performing area was ultra long dated bonds with returns close to 2.50%.

### Overseas and credit index linked market

- Overseas index linked government bonds outperformed index linked gilts, with yield differentials returning to levels seen at the time of the Consumer Prices Advisory Committee announcement in January 2013.
- 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 higher with a long dated syndication at the end of July.
- Long breakeven inflation rates of above 3.43% are now marginally above our 2014 year-end target; we expect them to stabilise as RPI inflation picks up later in the year.
- Our real yield forecasts for 10 and 30 year index linked gilts at the end of 2014 are 0.40% and 0.60%, respectively, significantly higher than current levels.

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# BOND MARKET REVIEW

## Overseas government bonds

### Key points

- Weak eurozone inflation prompted the European Central Bank (ECB) to introduce measures aimed at stimulating the eurozone economy, including negative interest rates and a new package of longer-term refinancing operations to aid lending.
- Employment data in the US remained firm but was not sufficient to change the monetary policy debate; the Chair of the US Federal Reserve, Janet Yellen, reiterated that a high degree of monetary policy accommodation remained warranted.
- Instability in Ukraine receded as a ceasefire was agreed between the newly elected pro-Western government and pro-Russian separatists.
- Rating agencies upgraded several European sovereign credit ratings, including those of Spain, Greece, Portugal and Ireland.
- The New Zealand central bank raised interest rates twice over the quarter to 3.25%.

### Yield curve moves over the quarter

- Yields fell over the quarter in all regions as European inflation was weak and government bond markets priced in a lower profile for European base rates over the medium term.
- A lack of strong data within the US supported bond markets further.
- Firmer activity data in the UK led the gilt market to underperform as yields fell by less than other government bond markets.
- At the end of the quarter, 10 year government bond yields in the US, Germany, Japan and the UK were 2.53%, 1.24%, 0.56% and 2.67% respectively.
- At the end of the quarter, 10 year real yields in the US, Germany and the UK were 0.25%, -0.30% and -0.24%.
- Implied inflation posted small rises in the US, but declined in Europe and the UK. At the end of the quarter, implied (breakeven) inflation rates were 2.25%, 1.36% and 2.91% respectively.
- Yield curves flattened as very short dated bonds posted only small yield declines.

### Currency markets

- Over the quarter, sterling strengthened against the basket of currencies in the indices.
- The largest moves were against the European currencies (Sweden, Denmark).

### Outlook

- We expect that global economic growth will be subdued over the near term although, in our view, the risk of significant double dip recession has reduced.
- Events in Europe will continue to dominate market sentiment. Given the historic political capital invested in the region and the extremely negative consequences of a breakup, we expect the eurozone to survive but the transition to greater fiscal and political unity to be volatile. Near term, however, the situation remains unpredictable.
- Given the low level of real yields, we expect a moderate rise from current levels, though this will be limited by anaemic global growth prospects and a broadly supportive backdrop for bonds.
- In the wake of a very deep recession, we do not see an immediate period of sustained inflation, unless economic growth turns out to be much faster than we expect. In the medium term, however, we see upside risks to inflation given the large amount of recent monetary and fiscal stimulus.
- We expect no change in rates from major central banks over the near term and, when they do rise, we expect them to plateau at a very low level compared with past standards.

ROYAL LONDON

# BOND MARKET REVIEW

## Global high yield bonds

### Key points

- Global high yield bonds (described by the Bank of America Merrill Lynch BB-B Global Non-Financial High Yield Constrained Index, 100% hedged to sterling) returned 2.91% over the quarter, with monthly returns relatively consistent over this period (April: 0.82%, May: 1.15%, June: 0.92%). Year to date, global high yield bonds have returned 5.79%.
- The best performing sectors in the quarter were energy (4.42%) and real estate (4.07%). Services (2.05%) and autos (1.75%) were relative laggards.
- Global new issuance in the quarter was over $162 billion, up over 40% on the same period last year. This was due primarily to a low level of issuance during June 2013, which followed the interest rate sell off. Year to date, issuance is only 3% more than last year; quarter two issuance, particularly in Europe, has made up for the weak start to 2014.
- The yield on the index ended the quarter 0.22% lower at 4.64% with the average high yield credit spread at 3.34% above government bond yields, having tightened 0.13% from the level prevailing at the end of March. This spread is well above the all-time low of 1.96%, set in May 2007.

### Regions

- US and Canada returned 2.52% over the quarter (5.60% year to date). Credit spreads tightened by 0.26%, while underlying government yields were 0.10% lower. Performance was produced incrementally over the three month period.
- Having outperformed in quarter one, Europe underperformed in quarter two, returning 2.30% (5.54% year to date). Credit spreads rose in May and June, offset by lower government yields as the European Central Bank introduced measures to stimulate the economy. Credit spreads widened by 0.12%, while underlying government yields were 0.17% lower.
- The Emerging Markets was the strongest performing region, returning 5.51% in the quarter (7.47% year to date), and rebounding from a poor first quarter of both investor outflows and pressure on local currencies. Spread tightening accounted for virtually the entire move lower in yields, contracting by 0.90%, while underlying government yields were 0.03% lower.

*Using BofA Merrill Lynch Indices: H0UC for US and Canada, HEEC for Europe, EMHB for Emerging Markets, all 100% hedged to sterling.*

### Monthly performance

- Positive returns in the global high yield market accumulated in a consistent manner over April, produced against a backdrop of volatile equity markets and ongoing Russian-Ukrainian conflict concerns. Only two separate days produced negative returns during the month. The theme of tightening credit spreads continued, hitting the lowest level since late 2007. This was mainly due to strong economic data and robust corporate earnings.
- During May, positive returns continued with little volatility as economic data was broadly in line with expectations and Russian-Ukrainian conflict concerns continued to abate. The ongoing theme of tightening credit spreads stalled, while lower underlying government yields drove market performance.
- During June, generally positive economic data drove market performance, while all-time low government yields in Europe drove incremental performance. Economic data was mixed in the US, with strong payrolls and a six-year low unemployment rate offset by a weaker revision to GDP.

### Ratings & maturities

- For the quarter, the various credit rating baskets performed broadly in line with one another. BB and B rated bonds returned 2.92% and 2.90% respectively. Outside of the benchmark, the Global High Yield CCC & Lower index returned 2.81%, illustrating how position based upon credit rating had little effect on overall performance.
- Longer maturities gave higher returns due to greater spread compression and lower underlying government yields. Returns were 1.76% for 0-3 years, 2.37% for 3-5 years, 2.54% for 5-7 years, 3.52% for 7-10 years and 7.40% for over 10 years.

### Outlook

- We expect the performance of the US recovery to underpin the growth in the global economy in the medium term, despite more challenging economic conditions within the eurozone.
- We expect bouts of market volatility due to the withdrawal of supportive monetary policy by the US Federal Reserve. 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 default risk, 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.

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# INVESTMENT OUTLOOK

## Key points

- Our central case assumes 3.0% gross domestic product (GDP) growth in the UK in 2014, continued modest growth in the Eurozone, and a marked improvement in US growth during the second half of the year.
- We expect UK interest rates to remain on hold at 0.5% until early 2015 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

- Global GDP slowed in the first quarter of 2014, primarily as a result of weaker activity in the US and Emerging Economies, including China. More recent evidence suggests some improvement in quarter two, particularly in the US and China, and we expect global growth to improve in the second half of the year.
- The US economy slowed sharply in quarter one, mainly due to temporary factors; conditions have improved during the second quarter. Our base case now assumes GDP growth of 1.7% in 2014, with the second half markedly stronger than the first. This takes into account the slower pace of fiscal consolidation going forward, while private sector demand is underpinned by an improving labour market and still supportive financial conditions. Next year, we assume growth rises to 3% per annum.
- The eurozone economy grew by 0.2% in quarter one, less than survey data were suggesting. With the pace of fiscal tightening set to ease, and confidence measures moving higher, we maintain our base case forecast of 1% GDP growth for 2014. Downside risks remain, including the extent to which lower sovereign bond yields are passed through to the private sector. Persistently low inflation and the possibility of outright deflation in the Eurozone remains a downside risk to our global and UK outlook.
- The UK economy has continued to surprise to the upside; survey data suggest growth in quarter two is at least as robust, if not a little stronger, than in quarter one. Household spending remains the main motor of growth, as employment levels continue to rise. However, growth is now better balanced than before, with a sharp increase in business investment. We now forecast 3% GDP growth for 2014, above the UK's long term trend, slowing a little in 2015 in response to tighter policy.
- In China, we expect growth of less than the official target of 7.5%. Growth was weaker than expected in quarter one. However, there have been signs of improvement in quarter two, in particular stronger business surveys. In Japan, growth is expected to be 1% in 2014, slower than in 2013, as the effects of the initial 'Abenomics' stimulus wear off and consumption taxes are raised.

## Inflation and growth – how will they impact interest rates?

- Inflation, as measured by the UK consumer price inflation (CPI) index, fell to 1.5% in May, in part due to the latest supermarket price war and stronger sterling. A number of the major energy companies have announced that they will not increase their prices over 2014, unless there is a substantial increase in wholesale electricity costs. We assume a gradual firming in wage growth, as the labour market tightens, which should keep CPI close to 2% by year end. During 2014, we expect higher house price inflation to boost RPI relative to CPI and, over the 12 months, that rising mortgage interest rates will also push RPI higher.
- In February, the Bank of England (BoE) 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 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. While this guidance remains in place, Governor Carney has signalled that the first rate rise could come later in 2014.

## Our views on the outlook for the main bond asset classes

- Against expectations government bond yields have fallen since the beginning of the year and investors continue to pay a high price for the prospect of low real returns. We expect yields to move higher from current levels, as US economic data improves and we move closer to rate hikes from both the Federal Reserve and BoE. Our base case assumes a very gradual rise in policy rates, so we do not expect a dramatic sell-off in government bond markets over the next 12 months.
- 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 1.20% p.a. over the next three years.

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# SPECIAL TOPIC

## Active versus passive management of bonds

As a leading UK exponent of the benefits of an active approach to bond management, RLAM firmly believes that an active approach will give rise to superior long term returns, particularly for credit bonds. This is based on particular aspects of the asset class and the benchmark indices used to represent it, giving the active manager advantages over the passive manager. The asymmetry of credit bonds favours the active manager.

Fundamentally, the risk and return characteristics of bonds are different from equities, enabling an active bond manager to improve the risk and return characteristics of a portfolio versus its benchmark. Specifically, bond managers do not have a normal distribution of individual holding returns within their portfolios. They are unlikely to have any stellar performances within portfolios, or within benchmark constituents. Therefore there are relatively few or no benchmark constituents a bond manager must hold in order to manage tracking error compared to benchmark. This is different from an equity fund manager where positioning relative to benchmark in the largest constituents can make or break performance. Furthermore, as there are unlikely to be individual 'winners' to offset laggards, managing the 'downside risk' of individual holdings is a critical aspect of bond fund management and flexibility from benchmark positioning facilitates this aspect of fund management.

In contrast to active managers, passive managers buy the universe of stocks (or a representative subset) that comprises the chosen benchmark. Unlike an equity index, which broadly reflects the economic contribution a company makes (through profits), a bond index reflects the amount of debt a company has issued i.e. the more debt a company issues, the heavier their weighting in the index.

At RLAM, we only hold bonds that offer the prospects of attractive returns within the context of our clients' performance objectives and risk tolerances. If we dislike the risk and return characteristics of a bond, then we do not have to hold it. This may sound like we are introducing high tracking error (risk) into portfolios but this is not the case. This is because of the asymmetric risk profile of corporate bonds addressed above i.e. not much upside but considerable downside in individual bonds. Therefore, not holding a bond that is a large part of an index (because we dislike its risk profile) does not introduce much tracking error. Even if we are incorrect in our assessment and the company performs well, the impact on the bond price will not be significant. Conversely, if we are correct, the price impact could be dramatic and involve a significant loss of value for the bondholder.

### Inefficiencies in credit markets

Our belief that active credit management produces better results than passive management is reinforced by the narrower selection base available to passive managers. By definition, the passive manager is restricted to index constituents, thereby excluding many bonds that are not eligible for index inclusion. The main UK credit indices apply the same criteria for benchmark eligibility, of which the most constraining relate to issue size and credit rating.

**Issue Size:** A minimum new issue size of £250m for inclusion in benchmarks means smaller sized bonds are excluded, regardless of quality or price. The active manager is not constrained and may benefit because this bond will be overlooked by passive managers and 'benchmark huggers' (those managers who say they are active but who, in reality, follow benchmark weightings).

**Credit Rating:** For inclusion in an investment grade benchmark, a bond must be rated BBB- or above. Restricting holdings to rated bonds excludes many debt issues that are undervalued. Most bonds without a credit rating are not sub investment grade. In fact, many unrated bonds have inherently attractive risk/return characteristics; in many instances, they are backed by specific commercial property or financial assets, making the bonds more robust against adverse change.

This highlights aspects of how corporate bond markets have developed over time, with an emphasis on credit rating and market liquidity, in preference to inherent security and value. Specifically, rating agencies are focused on a "point in time" assessment of default probability. There is little focus on any protection of the investor's interests should the company's financial fortunes deteriorate, which is critically important to an appropriate assessment of value from an investor's perspective.

To illustrate, General Motors was rated AAA before its Chapter 11 bankruptcy in 2009. Passive managers are forced to sell when a credit rating downgrade (below BBB-) triggers expulsion from the benchmark index. Given the market's ability to price credit events ahead of actions by credit rating agencies, such sales are likely to be at depressed price levels.

### Managing interest rates

Portfolio duration measures the sensitivity of the assets to the movement in long term interest rates. While the passive manager is indifferent to whether interest rates move up or down, the active manager will use judgment to shape portfolios to reflect the expectation of movement in long term interest rates. Whilst there is no guarantee that interest rate movements will be correctly assessed, the active manager does have the flexibility to change the characteristics of the portfolio when markets appear very cheap or expensive – an option not open to the passive manager.

### Sector concentration

Credit indices are biased towards supranational and financial bonds. For example, in the iBoxx Sterling Non-Gilt index, the two largest issuers account for 10.9% of the index (EIB and KFW), and five banks/financial service companies are in the next ten largest issuers. The active manager has the advantage of not mechanically exposing clients to concentrated sector/issuer risk.

# 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

- 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 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 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 TEAM

## Your fund managers

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## Your dedicated contact

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## Fixed interest team changes

We welcome Arnaud Martel to the Global High Yield Team as an Assistant Credit Analyst. Arnaud joins us from Moody's where he was an Associate Analyst researching investment grade telecom issuers and high yield names. Arnaud holds a bachelor's degree in Business Administration from the ICN business school in France, a Master's degree in Management from Toulouse Business School and has an MSc in Finance and Financial Regulation from Aston University.

Matt Franklin has joined the fixed interest team as a Trainee Credit Analyst. Prior to joining the team Matt worked within Royal London's risk team as an Analyst. Matt has a degree in Economics from Durham University and is also a certified Financial Risk Manager (FRM).

## Distribution team changes

James Stoddart has taken over as Head of Client Account Management (which includes the Client Relationship Managers and the Client Service Team) following the departure of Victoria Muir to a new role within a leading Hedge Fund Manager.

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## GLOSSARY

**ABS** – Asset backed securities – Debt secured against assets of the issuer.

**Amortisation** – Incremental repayment of a bond over its lifetime.

**Attribution** – The measurement of a fund's return versus the underlying benchmark return that breaks up the active performance into component parts:

**Stock selection** – Performance attributed to stock selection.

**Yield curve** – Performance attributed to positioning on the yield curve.

**Duration** – Performance attributed to relative duration of the portfolio versus that of the benchmark.

**Asset allocation** – Performance attributed to asset allocation between fixed interest gilts and credit bonds.

**Basel** – The Basel Committee on Banking Supervision provides a forum for regular global co-operation on banking supervisory matters.

**Benchmark** – An index or other market measurement that is used by an investment manager as a standard against which to assess the risk and performance of a portfolio.

**Book cost** – A measure of the historical cost of a bond or a portfolio of bonds represented as a clean value. It is calculated as the product of the number of bonds held and the average price paid. It remains unchanged regardless of movements in market price. If the price paid is the same as the face value of the bond, book cost will be the same as the nominal value.

**Breakevens** – The level of inflation required to make the return on index linked bonds equal to return on conventional bonds of similar maturity.

**Capital cover** – The degree to which debt is covered by the assets of the issuer.

**Certificate of deposit (CD)** – A certificate of deposit is a negotiable receipt issued by a deposit taking institution in respect of a specified sum of money deposited with that institution at a fixed rate of interest, with an undertaking to repay to the bearer of the certificate at a specified date the sum deposited with interest outstanding. The term of a CD generally ranges from one month to five years – with annual interest payments for those that are issued for longer than a year.

**CDO** – Collateralized debt obligations – A relatively small subset of the wider ABS market, CDOs are securitisations of a pool of debt receivables (that are not secured on tangible property). Typically, these securities are divided into different tranches: senior tranches, mezzanine tranches and equity tranches. Losses are applied based on the seniority of the tranche, with the most junior tranche absorbing losses first. The bonds are tranched to provide investors with different levels of seniority and credit rating. Variations include collateralised loan obligations (CLOs) and collateralised synthetic obligations (CSOs), where the underlying pools of assets are corporate loans and credit default swaps (that are not secured on tangible property).

**Consumer price index** – An index number calculated as the weighted average price of consumer goods and services.

**Coupon** – Interest paid by the bond issuer expressed as a percentage of the face value of a bond; typically paid annually or semi-annually.

**Covenant** – Legal rules found in bond documentation that place restrictions on the issuer.

**Covered bond** – Senior bonds issued by banks and collateralised by a high quality pool of residential mortgage assets.

**CDS** – Credit default swaps – Insurance purchased to protect against the default of a bond. In the event of default, the CDS buyer receives the face value of the bond in return for delivering the bond to the provider of protection.

**Credit rating** – A rating agency (Moody's, S&P, Fitch) measure of the credit worthiness of a bond issuer – investment grade credit ratings range from AAA to BBB with BB and below referred to as sub-investment grade (sometimes known as 'junk bonds' or 'high yield'). In general, for investment grade credits the rating agency rates only on the probability of default and does not take into account the potential recovery prospects of the bond.

**Credit spread** – Extra yield offered to compensate the holder of a credit bond versus an underlying risk free bond of similar maturity. Specifically, the holder requires compensation for the expected loss on default, reflecting a combination of probability of default and recovery rate on default. Compensation may also be required for extra market risk and liquidity risk.

**Cyclicals** – Bonds/stocks that are sensitive to the economic cycle.

**Default** – Failure of a bond issuer to pay the coupon, or principal when required, on a debt instrument.

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

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

**ECN** – Enhanced capital notes. ECN is a subordinated debt instrument issued by Lloyds Banking Group as part of the 2009 capital restructuring. The bonds were issued in exchange for Lloyd's existing upper tier 2 and tier 1 bonds and are lower tier 2 in the capital structure. Although the regulator also classifies these instruments as LT2, for the purposes of stress testing they are included in the equity capital base of the bank. Coupon payments of ECNs are not deferrable and the bonds are dated. However, should the core tier 1 capital ratio fall below 5%, the ECNs will mandatorily convert into equity.

**European Financial Stability Facility (EFSF)** – Agreed in May 2010 by EU member states, the temporary program can issue bonds or other debt instruments to raise funds needed to provide financial assistance to eurozone states in economic difficulty. The EFSF is financed by members of the eurozone.

**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).

**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.

Royal London Asset Management is a marketing group which includes the following companies:

Royal London Asset Management Limited provides investment management services, registered in England and Wales number 2244297; Royal London Cash Management Limited provides investment management services, registered in England and Wales number 1963229; Royal London Unit Trust Managers Limited manages collective investment schemes, registered in England and Wales number 2372439. RLUM (CIS) Limited (previously CIS Unit Managers Limited), registered in England and Wales number 2369965. All of these companies are authorised and regulated by the Financial Conduct Authority.

Royal London Pooled Pensions Company Limited provides pension services, authorised by the Prudential Regulation Authority and regulated by the Financial Conduct Authority and the Prudential Regulation Authority, registered in Scotland number SC048729.

All of these companies are subsidiaries of The Royal London Mutual Insurance Society Limited, registered in England and Wales number 99064. Registered Office: 55 Gracechurch Street, London, EC3V 0RL. The marketing brand also includes Royal London Asset Management Bond Funds Plc, an umbrella company with segregated liability between sub-funds, authorised and regulated by the Central Bank of Ireland, registered in Ireland number 364259. Registered office: 70 Sir John Rogerson's Quay, Dublin 2, Ireland.

# Portfolio Valuation

As at 30 June 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** | | | | | | | | | |
| | 110,811,014 | RLPPC Over 5 Year Corp Bond Pen Fd | 1.83355 | 121,425,874.14 | 203,177,535.51 | 0.00 | 203,177,535.51 | 0 | 100.0 |
| | | | **Funds Held total** | **121,425,874.14** | **203,177,535.51** | **0.00** | **203,177,535.51** | | **100.0** |
| | | | **Grand total** | **121,425,874.14** | **203,177,535.51** | **0.00** | **203,177,535.51** | | **100.0** |

# Trading Statement

For period 01 April 2014 to 30 June 2014

## Dorset County Pension Fund

| | Trade Date | Transaction Type | Nominal | Security | Price (£) | Book Cost (£) |
|---|---|---|---|---|---|---|
| **Acquisitions** | | | | | | |
| **Funds Held** | | | | | | |
| | 07 Apr 2014 | Acquisition Rebate | 80,183.41 | RLPPC Over 5 Year Corp Bond Pen Fd | 1.82 | 145,683.64 |
| | | | | | **Funds Held total** | **145,683.64** |
| | | | | | **Acquisitions total** | **145,683.64** |