# DORSET COUNTY PENSION FUND

## Quarterly Report 30 September 2014

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# YOUR PORTFOLIO

## Fund performance objective

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

## Fund asset allocation and benchmark ranges

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

## Portfolio value

| | Portfolio total (£m) |
|---|---|
| **30 September 2014** | **261.26** |
| 30 June 2014 | 203.18 |
| Change over quarter | 58.08 |
| Net cash inflow (outflow) | 50.00 |

# EXECUTIVE SUMMARY

## Performance

- The fund gave a  return of 3.54% over the quarter, compared with a benchmark return of 3.76%. This brings year to date performance to 10.58% versus the benchmark of 9.65%.

## The economy and bond markets

- The UK economy has continued to surprise, growing by 0.9% in quarter two, and business surveys suggested the positive momentum continued into the second half of 2014. UK consumer price index (CPI) inflation fell to 1.5% year-on-year in August, in part reflecting an intensification of the latest supermarket price war. Bank of England (BoE) officials again gave mixed messages about future base rate rises, in a dovish August inflation report, while the Monetary Policy Committee minutes highlighted a spilt vote of 7-2 in favour of maintaining policy.
- US GDP grew by 4.6% annualised in quarter two, while recent business surveys and labour market data suggested that growth continued at a reasonable pace in quarter three. 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.
- Eurozone growth continued to disappoint and was flat in the quarter, with negative news concentrated in Germany, France and Italy. Survey data in quarter three have given little indication of improvement. The European Central Bank (ECB) cut its main refinancing rate to another record low of 0.05% to stave off the threat of disinflation becoming deflation and announced a programme of asset purchases.
- Growth in China was weaker than expectations in quarter one and, although there was a pick-up in quarter two, economic news since then has been softer. Growth in Japan slumped in quarter two as the effect of a hike in VAT, from 5% to 8%, unwound. We expect growth to resume in quarter three.
- Conventional gilts returned 3.73% over the quarter, with medium dated gilts outperforming short and long dated gilts, as the market rallied on increasing geopolitical risks, and on the fear that deflation would lead to full scale quantitative easing in Europe. Index linked gilts posted very strong returns of 5.32% for the quarter, as longer dated real yields fell to record lows. Breakeven (implied) inflation rates, particularly for shorter dated bonds, fell as inflation remained low and average earnings data continued to disappoint.
- Sterling investment grade credit bonds returned 2.90%, underperforming government bonds. Subordinated financial bonds performed poorly, reflecting increased risk aversion in the latter part of the quarter. Outside of financial sectors, asset backed securities performed well. Credit spreads increased over the quarter, ending the period 1.13% above government bond yields. Global high yield bonds returned -1.35%.

## 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 the next 12 months is not our central forecast. We believe that long term real interest rates of -0.3% are too low and do not reflect long term economic fundamentals. We expect returns from investment grade corporate bonds to exceed government bonds by approximately 1.25% p.a. over the next three years.

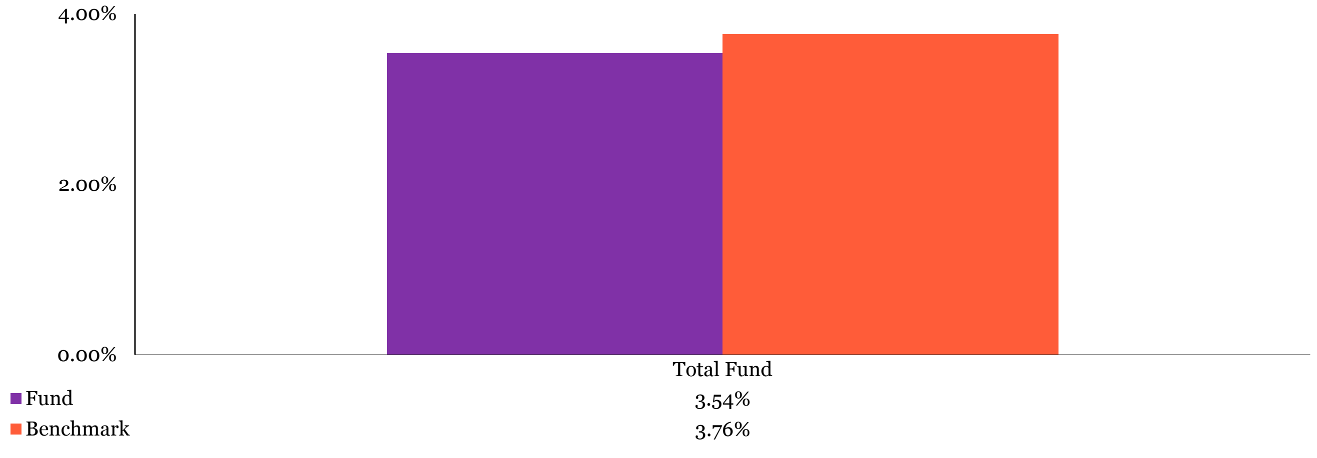
# FUND PERFORMANCE

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

## Performance

| | Fund (%) | Benchmark (%) | Relative (%) |
|---|---|---|---|
| **Q3 2014** | 3.54 | 3.76 | -0.22 |
| Year to date | 10.58 | 9.65 | 0.93 |
| Rolling 12 months | 11.33 | 9.39 | 1.94 |
| Three years p.a. | 12.72 | 10.25 | 2.47 |
| Five years p.a. | 12.44 | 9.95 | 2.49 |
| Since inception 02.07.07 p.a. | 9.64 | 10.00 | -0.36 |

## Quarterly performance




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

# RLPPC UK OVER 5 YEAR CORPORATE BOND FUND

## Quarter 3 2014

### Asset split

| | Fund (%) | Benchmark[1] (%) |
|---|---|---|
| Conventional credit bonds[2] | 97.1 | 98.7 |
| Index linked credit bonds | 0.0 | 0.0 |
| Sterling conventional gilts | 2.7 | 0.0 |
| Sterling index linked gilts | 0.0 | 0.0 |
| Foreign conventional sovereign | 0.2 | 1.3 |
| Foreign index linked sovereign | 0.0 | 0.0 |
| Derivatives | 0.0 | 0.0 |

### Fund data

| | Fund | Benchmark[1] |
|---|---|---|
| Duration | 9.9 years | 10.0 years |
| Gross redemption yield[3] | 4.20% | 3.76% |
| No. of stocks | 230 | 719 |
| Fund size | £262.6m | - |

*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 (%) |
|---|---|---|---|
| **Q3 2014** | **3.71** | **3.76** | **-0.05** |
| Year to date | 10.66 | 9.65 | 1.01 |
| Rolling 12 months | 11.44 | 9.39 | 2.05 |
| Since inception p.a. (02.07.2012)[2] | 10.78 | 8.38 | 2.40 |

[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.*

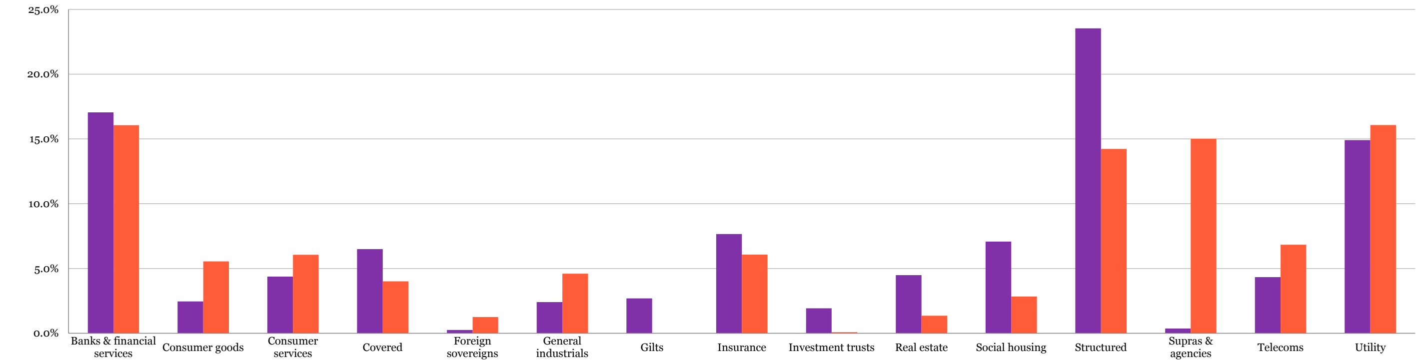
The fund objective is to outperform the benchmark by 0.80% per annum gross of the standard management fees.

The fund returns in the above table are gross of standard management fees and include the impact of cash holdings over the period.

# RLPPC UK OVER 5 YEAR CORPORATE BOND FUND

## Quarter 3 2014

### Sector breakdown




| | Banks & financial services | Consumer goods | Consumer services | Covered | Foreign sovereigns | General industrials | Gilts | Insurance | Investment trusts | Real estate | Social housing | Structured | Supras & agencies | Telecoms | Utility |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| PPLCP | 17.1% | 2.5% | 4.4% | 6.5% | 0.3% | 2.4% | 2.7% | 7.7% | 1.9% | 4.5% | 7.1% | 23.5% | 0.4% | 4.3% | 14.9% |
| Benchmark | 16.1% | 5.5% | 6.1% | 4.0% | 1.3% | 4.6% | 0.0% | 6.1% | 0.1% | 1.4% | 2.8% | 14.2% | 15.0% | 6.8% | 16.1% |

***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.*

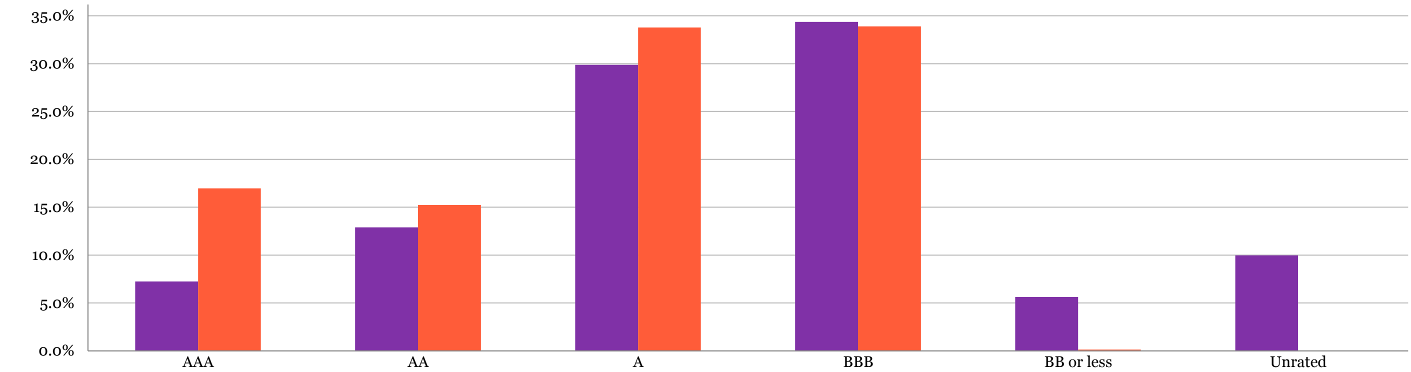
| What we thought | What we did | What happened | Effect on portfolio |
|---|---|---|---|
| We expected that corporate bonds would outperform supranational debt. | A significant underweight exposure to supranational and agency debt was maintained. | Supranational bonds marginally outperformed the overall sterling credit market over the quarter. | The underweight position in supranational debt was a drag on fund performance. |
| We expected that higher yielding bonds would outperform investment grade debt. | We maintained exposure to higher yielding debt via the Royal London Sterling Extra Yield Bond Fund. | High yield debt underperformed investment grade bonds. The Royal London Sterling Extra Yield Bond Fund returned 2.07% over the quarter, bringing year to date returns to 9.08%. | The exposure to higher yielding debt was a negative contributor to relative performance. However, year to date, the allocation to the Royal London Sterling Extra Yield Bond Fund has been a significant benefit. |
| We continued to prefer a combination of covered bank bonds and subordinated bank debt to senior bonds. | The broad structure of the fund's financial bond exposure was maintained. | Subordinated financial bonds were the weakest area of the sterling credit market in quarter three, reflecting increased risk aversion in the latter part of the period. Covered bonds were the best performing sector within sterling corporate bond markets over the quarter, outperforming senior unsecured debt. | Positioning within the fund was detrimental to performance, reflecting the exposure to subordinated bank debt, which was only partially offset by beneficial exposure to covered bonds. |
| We thought that high profile consumer orientated bonds were unattractively priced relative to corporate debt. | We maintained an underweight exposure to such bonds. | Weakness in the food retailing sector, reflecting an intensification of the latest supermarket price war, resulted in consumer bonds, specifically UK retailers, underperforming the overall sterling credit market. | The low weighting in high profile consumer debt was marginally supportive to performance. |

| What we thought | What we did | What happened | Effect on portfolio |
|---|---|---|---|
| We continued to believe that secured bonds were undervalued relative to unsecured debt. | We maintained a significant overweight position in sectors that benefit from enhanced security e.g. asset backed securities (ABS), social housing and investment trusts. | Secured and ABS bonds outperformed the overall sterling credit market, reflecting their more defensive characteristics, and supported by the knock-on impact of the European Central Bank's announcement of quantitative easing in the form of an ABS and covered bond purchase programme. | The exposure to secured and ABS bonds was a small positive to fund performance over the quarter. |

# RLPPC OVER 5 YEAR CORPORATE BOND FUND

## Quarter 3 2014

### Rating breakdown




| | AAA | AA | A | BBB | BB or less | Unrated |
|---|---|---|---|---|---|---|
| PPLCP | 7.2% | 12.9% | 29.9% | 34.4% | 5.6% | 10.0% |
| Benchmark | 17.0% | 15.2% | 33.8% | 33.9% | 0.1% | 0.0% |

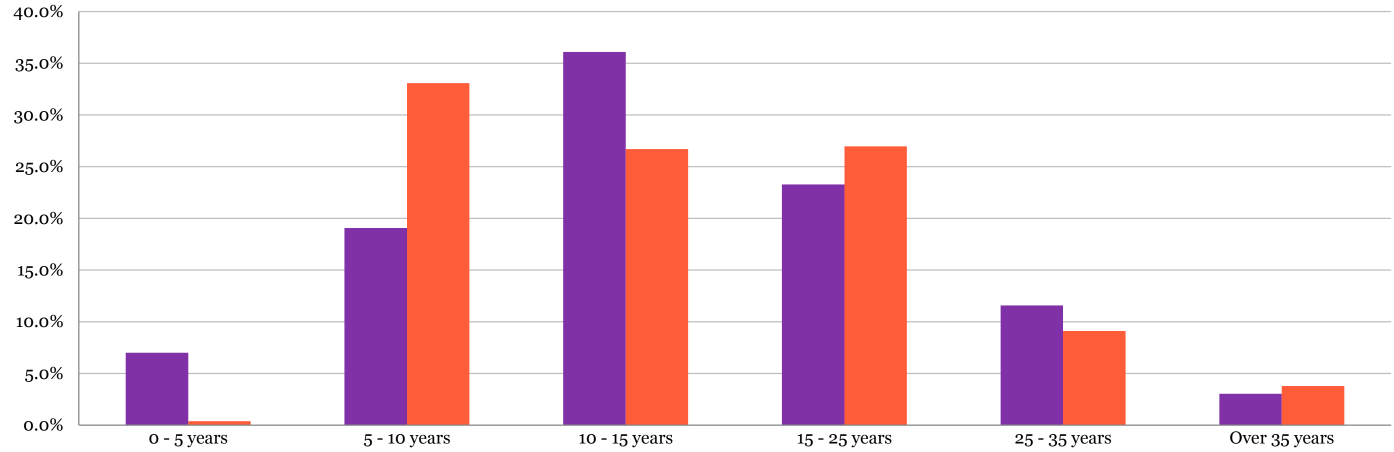
***Source:*** *rlam. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio.*

| What we thought | What we did | What happened | Effect on portfolio |
|---|---|---|---|
| We believed that lower rated bonds offered better value than AAA / AA rated securities. | The fund's credit rating profile was broadly maintained. | Reflecting heightened risk aversion, particularly in the latter part of the quarter, following the well-flagged rating methodology change by S&P that resulted in downgrades of many European banks, BBB rated bonds reversed their strong performance of recent quarters. The rating band was the poorest performing area over the period, returning 2.09%.<br>Year to date, the BBB rating band remains the best performing area, on a duration adjusted basis. | The credit rating profile of the portfolio was detrimental to overall fund performance. |

# RLPPC UK OVER 5 YEAR CORPORATE BOND FUND

## Quarter 3 2014

### Maturity profile




| | 0 - 5 years | 5 - 10 years | 10 - 15 years | 15 - 25 years | 25 - 35 years | Over 35 years |
|---|---|---|---|---|---|---|
| PPLCP | 7.0% | 19.1% | 36.1% | 23.3% | 11.6% | 3.0% |
| Benchmark | 0.4% | 33.1% | 26.7% | 27.0% | 9.1% | 3.8% |

***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 volatile quarter two, we expected UK government bond yields to rise moderately over the remainder of the year towards our year end forecast. | The overall bias of the portfolio was to be short duration, versus the benchmark index, throughout the quarter. | Ongoing geopolitical tensions (Ukraine and the Middle East) as well as the significant monetary policy announcement by the European Central Bank (further rate cuts and commencement of quantitative easing) drove government bond yields lower. This downward trend was briefly interrupted by the Bank of England minutes split vote on rate hikes and nervousness leading up to the Scottish referendum vote.<br>By the end of the quarter, however, bond yields declined across the yield curve, with yield decreases greatest at longer maturities. | The short duration position maintained over the quarter was a negative 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 and further-reduced the exposure to short dated bonds. | Medium dated bonds performed relatively well; the lowest returns were achieved by short dated bonds. | Yield curve positioning was a modest beneficial factor in fund performance. |

# RLPPC UK OVER 5 YEAR CORPORATE BOND FUND

## Quarter 3 2014

### Ten largest holdings

| | Rating | Weighting (%) |
|---|---|---|
| UK Treasury 4.25% 2027 | AA+ | 2.7 |
| Lloyds Bank Plc 6% 2029 | AAA | 1.4 |
| Annington Finance 0% 2022 | AAA | 1.2 |
| Finance for Residential Social Housing 8.369% 2058 | A- | 1.1 |
| Great Rolling Stock Co Plc 6.875% 2035 | BBB | 1.0 |
| Equity Release Funding 5.88% 2032 | A | 1.0 |
| Equity Release 5.7% 2031 | A | 1.0 |
| Abbey National Treasury 5.75% 2026 | AAA | 1.0 |
| Co-operative Bank 4.75% 2021 | BBB- | 0.9 |
| Bank of America 7% 2028 | A- | 0.9 |
| **Total** | | **12.2** |

***Source:*** *rlam. Figures in the table above exclude derivatives where held.*

# RLPPC UK OVER 5 YEAR CORPORATE BOND FUND

## Quarter 3 2014

### Fund activity

- New issuance activity within the fund was subdued, reflecting quarter three issuance running noticeably below comparable periods in recent years. Nonetheless, the fund participated in several attractive new offerings across sectors over the period. These included **Ayr**, a £107.26m five-year floating rate bond secured against four UK student accommodation blocks in Nottingham, Sheffield and Leicester. Under the terms of the issue, the loan-to-value (LTV) of the transaction must not exceed 80%; at issue the prevailing LTV was 60%. The bond is rated A by S&P, reflecting the quality of the underlying security i.e. purpose-built student accommodation, located in popular university towns.
- Within the social housing sector, we purchased a new issue from residential social landlord **Boston Mayflower**, a AA-rated housing association focused in Lincolnshire. The bonds came at an attractive credit spread of 1.3% above the reference gilt yield, representing good value versus other housing associations with comparable credit metrics. Towards the end of the quarter we then participated in a second debut transaction, an A2 rated, long-dated bond from **Walsall Housing Group**, one of the largest social housing providers in the West Midlands with a portfolio of over 19,000 properties. The bond was priced at an attractive 1.25% over the reference gilt yield.
- The fund also purchased a new holding in **Scentre Management**, an unsecured bond issued by a leading Australian property company (the Westfield brand). Scentre Group has been formed following the restructuring of the larger Westfield Group, which has de-merged its Australia/NZ business. The company is an Australian REIT comprising of the Westfield Group Australian/NZ and Westfield Retail Trust assets. Following the transaction, it now has a portfolio of 47 shopping centres. The new entity is rated A/A1 and issued a £400m 12 year bond with common REIT covenants protection, priced at 1.13% above the benchmark gilt. Whilst RLAM generally prefer secured real estate exposure, it was felt that the offered spread was attractive, given the risk profile of the issuer. The bonds were well received and performed strongly in the secondary market following their launch.
- Within the consumer sectors, we participated in a 12 year transaction from **Motability**. Motability is a charitable organisation whose primary role is to undertake the Government's scheme to provide and assist disabled people with their personal mobility, principally through the provision of cars, powered wheelchairs and scooters.
- Towards the end of the quarter we purchased a hybrid issue from the French telecom operator, **Orange**. The issuance was prompted by the firm's recent announcement of its purchase of the Spanish mobile and broadband operator JazzTel for €3.8bn. The 8.5 year deal was priced at 5.75% with performance relatively subdued following launch.
- In the secondary market, we added to existing positions within the utilities (**Affinity Water, Wessex Water, APA** and **Northern Ireland Electric**) and financial sectors (**Barclays**, **LV**, **Rabobank** and **L&G**). In addition, we added to **Imperial Tobacco**, which had underperformed, **America Movil** hybrid bonds, which we believe look attractive following the recent announcement of disposals, and also purchased a new position in **FirstGroup**, a marked underperformer in recent months which we believe also looks attractive relative to the broader market and its peers.
- Sales over the quarter were limited. We reduced our exposure to telecoms provider **AT&T** and switched from a holding in **National Australia Bank** covered bonds to a similar maturity issue from **Clydesdale Bank**, at a meaningful yield premium. Within the structured sector, we sold our holding in **Residential Mortgage Securities**.
- Following the announcement of the splitting of its domestic assets, **Westfield** tendered for their 2022 maturity bonds at a yield of 0.15% over the benchmark gilt, a 0.70% spread premium to market valuations.

### Key views in your portfolio

- A significant underweight in supranational bonds, as we expect corporate bonds to outperform over the medium term.
- A short duration versus the benchmark, as we expect underlying gilt yields to rise moderately.
- A bias towards asset backed securities, an area that we believe still offers the best risk/return characteristics.
- An overweight position in subordinated 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.

# ECONOMIC REVIEW

## Key points

- Global growth rates remain some way below the pre-crisis average.
- In September, the European Central Bank (ECB) reduced its main refinancing rate to another record low of 0.05% and announced a programme of asset purchases.
- Two members of the Bank of England Monetary Policy Committee (MPC) voted to raise interest rates.

## Growth

- Global gross domestic product (GDP) growth slowed in the first half of 2014, primarily as a result of weaker activity in the US and China. Growth rates improved during the spring and summer, particularly in the US. Eurozone growth disappointed, however. Global growth rates remain some way below the pre-crisis average.
- US GDP grew by 4.6% annualised in quarter two, while recent business surveys and labour market data suggest growth has continued at a reasonable pace in quarter three. Employment grew by 245,000 per month, on average, over the six months to September, suggesting an improvement in labour market conditions. However, there is uncertainty about how persistent recent declines in labour force participation will prove to be and, therefore, about the extent to which higher labour demand will lead to a reduction in labour market slack and higher wage pressures. This remains the key issue for monetary policy.
- Eurozone growth has continued to disappoint. GDP was flat in the second quarter, with the downside news concentrated in Germany, France and Italy. Some of the weakness in Germany may have been down to erratic factors such as weather. However, survey data in quarter three have given little indication of improvement. It is likely that the weakening in business confidence, particularly in Germany, reflects the heightened tensions between Russia and Ukraine. Eurozone Purchasing Manager's Index (PMIs) continue to point to quarterly GDP growth of c.0.2% in quarter three that, even if sustained, would make the process of stabilising public and external debt in the periphery difficult.
- By contrast, the UK economy has continued to surprise to the upside. GDP grew by 0.9% in quarter two and the most recent business surveys (including the PMIs) suggest that positive momentum has continued into the second half of 2014, although the manufacturing sector has been impacted by uncertainty in the eurozone. Overall, growth looks to have been a little stronger than we expected, which has impacted our forecast for 2015 GDP growth. Business surveys suggest that corporate investment intentions remain strong, while net lending to non-financial businesses had also picked up. Consumer confidence remains well above its pre-crisis average.
- In China, we expect the economy will grow by less than the official target (7.5%). GDP growth was weaker than expectations in quarter one and, although there was a pick-up in quarter two, economic news since then has been softer, with industrial production data and the PMI surveys suggesting some slowdown in momentum. By contrast, export growth has accelerated, and the trade surplus hit record highs in both July and August. In Japan, GDP grew by 1.6% quarter-on-quarter in quarter one as demand rose ahead of a hike in VAT from 5% to 8%. GDP then slumped in quarter two, as this effect unwound. We expect growth to resume in quarter three.

## Inflation

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

## Interest rates

- In September, the ECB reduced its main refinancing rate to another record low of 0.05% and announced a programme of asset purchases. 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 MPC kept the bank rate at 0.5%, with the August Inflation Report suggesting that a rise in interest rates was likely in 2015. Two members voted to increase rates in August. 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 was flat over the quarter, as weakness versus the US dollar was offset by strength against the euro, but continues to trade 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 2.90% in the quarter, continuing the asset class' strong run, year to date.
- Credit spreads, the average yield differential between sterling investment grade credit bonds and gilts, increased from 1.05% to 1.13%; they ended the quarter higher across all sectors, with the exception of covered bonds.
- Subordinated financial bonds performed poorly, reflecting increased risk aversion in the latter part of the quarter; outside of financial sectors, asset backed securities performed well.

### Credit spreads

- Sterling investment grade credit bonds underperformed UK government bonds by 0.43%, duration adjusted.
- Credit spreads widened, with the average yield differential between sterling investment grade credit bonds and gilts increasing by 0.08% to end the quarter at 1.13%.
- Most non-government sectors saw a widening of credit spreads. Subordinated bank debt saw the greatest spread movement, as heighten risk aversion and rating agency downgrades impacted sentiment. Covered bonds saw a small spread compression in the quarter.
- Credit spreads remain wider than levels consistent with the long run corporate default rate.
- There was a discernible weakness in bonds issued by Scottish-based companies in the weeks prior to the independence referendum. However, most of this weakness was reversed following the "No" vote.

### Financial sectors

- Financial bonds underperformed those in non-financial sectors, with subordinated financial debt, especially tier 1 and upper tier 2 bonds, recording the lowest absolute returns (-0.65% and 1.08% respectively).
- Senior unsecured bank debt underperformed senior secured (covered) bonds, reflecting the fairly narrow differential that prevailed at the end of the second quarter.
- The insurance sector also underperformed, recording a spread widening of 0.23% and an absolute return of 1.47%.

### Non-financial sectors

- All sectors underperformed government bonds over the quarter.
- There were few themes in sector performance over the quarter. Consumer orientated bonds tended to underperform, with weakness in the food retailing sector being reflected in spread widening.
- Peripheral European corporate bonds maintained their relative recovery, despite increasing concerns about growth prospects in the Eurozone.

### Issuance, ratings and maturities

- Issuance in the third quarter was at its lowest level for the year to date; just over £4.5bn was issued, compared to £12.5bn and £14bn in the second and first quarters, respectively. The dearth of supply was driven by the usual seasonal factors, as well the Scottish referendum in mid-September, which kept borrowers on the sidelines pending the outcome. Issuance between financials and non-financials was evenly split, a continuation of a theme seen throughout 2014.
- Excess returns across the credit rating spectrum reflected risk characteristics; AAA rated bonds saw a slight spread compression and gave the highest excess returns, whilst BBB rated bonds underperformed. This reversed a trend that had been evident over the recent past.
- By maturity, the lowest absolute returns were recorded by the shortest dated bonds, with medium and longer maturity bonds generally outperforming the broader sterling credit market.

### Outlook

- Market conditions became more volatile in the latter part of the quarter. Nevertheless, 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 1.25% p.a. over the next three years.

# BOND MARKET REVIEW

## Conventional government bonds

### Key points

- Conventional gilts returned 3.73% for the quarter.
- The Bank of England (BoE) Monetary Policy Committee (MPC) left its policy rate and quantitative easing unchanged at 0.5% and £375bn, respectively.
- The MPC confused the market yet again with a dovish August Inflation report resulting in the market pricing out the potential for a rate rise in 2014. However the MPC minutes highlighted a spilt vote of 7-2, with Martin Weale and Ian McCafferty voting for a 0.25% hike.
- Conventional gilt issuance over the quarter was focused in the 10 to 20 year area. Index linked gilt issuance was biased more towards longer dated maturities; the Debt Management Office syndicated a new 0.125% coupon 2058 maturity index linked gilt, priced at -0.09%. The syndication went well, with a book of over £15bn for a £5bn issue. The market will now turn its attention to a conventional gilt syndication in October, which is likely to be a tap of the existing 2068 maturity issue.
- The European Central Bank (ECB) cut interest rates further to stave off the threat of disinflation becoming deflation. The main policy rate was cut to 0.05% and the deposit rate to -0.20%. In addition to the pre-announced LTRO (Long Term Repo Operation) programme, ECB president Mario Draghi announced that purchases of asset backed securities would begin in October.
- Duration adjusted, medium dated gilts outperformed short and long dated gilts as the market rallied on increasing geopolitical risks and on the fear that deflation will lead to full scale quantitative easing in Europe. Gilts outperformed both US and Europe over the quarter as supply was reduced due to the Scottish referendum. In addition, the BoE reinvested quantitative easing maturities.

### Yield curves move over the quarter

- Government bond yield curves in the UK flattened between 2 and 10 year maturities, and also between 10 and 30 years, as the bond market worried about global deflationary pressures. The curve steepened between 20 and 50 years as the market digested the 2058 index linked supply, as well as anticipating the 2068 conventional gilt syndication in October.
- Issuance in conventional gilts was focused in the 10 to 20 year area, with a long dated 2068 gilt syndication expected in October.

### Variation of return across the UK market

- Overall, the conventional UK government bond market returned 3.73% over the quarter, with short dated gilts returning 0.81%, medium dated gilts 2.98%, and long dated gilts 7.19%.

### Overseas fixed interest markets

- Yields in core overseas markets, including Germany, fell over the quarter, and peripheral eurozone markets, such as Italy and Spain, outperformed. However, gilts generally outperformed, 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, with 2 year maturity German government bonds trading at negative yields and 10 year bunds trading at yields below 1.0%.

### Outlook

- 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 US 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.
- Our central case is for gilt yields to rise further over the year, although we expect some volatility around this trend. Our 31 December 2015 forecasts for 5, 10 and 30 year conventional gilt yields are 2.6%, 3.4% and 4.0%, respectively; current yields are 1.8%, 2.4% and 3.1%, respectively.

# BOND MARKET REVIEW

## Index linked bonds

### Key points

- Index linked gilts posted very strong returns of 5.32% for the quarter, as longer dated real yields fell to record lows.
- UK consumer price index (CPI) inflation remained at 1.5% in August, its lowest rate in nearly five years. Retail price index (RPI) inflation was similarly unchanged at 2.4%. This left the 'wedge' between the measures at 0.9%, disappointing many investors who had believed the differential would widen as house price inflation gathered momentum.
- Real yields fell across the curve as fears of European deflation prompted further rate cuts in Europe, and the possibility of conventional quantitative easing increased. Geopolitical tensions and the Scottish referendum added to the volatility.
- Strong demand from pension funds for longer dated bonds led to a strong performance of index linked gilts, both on an outright basis and relative to overseas markets.
- Oil prices fell sharply over the quarter, despite escalating tensions in the Middle East.
- Breakeven (implied) inflation rates, particularly for shorter dated bonds, fell as inflation remained low and average earnings data continued to disappoint.

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

- The market began the quarter with real yields rising, marginally, prior to the 2058 syndication that eventually priced with a negative real yield. Subsequent strong demand then pushed long real yields to record lows of -0.4%. Shorter dated bonds underperformed.
- Breakeven inflation rates, particularly in the 5 to 10 year sector, fell over the quarter as inflation undershot forecasts, with CPI inflation remaining at its lowest level in nearly 5 years. The 'wedge' between CPI and RPI unexpectedly remained at 0.9% as a booming housing market was not reflected in a higher RPI inflation rate.

### Variation of return across the UK market

- The real yield differential between 10 and 30 year bonds fell by around 0.1%. 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 5.32% over the quarter, leaving the twelve month return at 8.79%. 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 in excess of 10%.

### Overseas and credit index linked market

- The performance of the index linked gilts versus overseas markets was mixed; gilts outperformed the US and Canada but underperformed Europe, particularly at the 10 year maturity point.
- 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 -0.3% are too low and do not reflect long term economic fundamentals.
- Pension fund demand remains strong for longer dated real yield securities. With no longer dated supply until early November, we anticipate a continued outperformance of longer dated bonds.
- Long breakeven inflation rates of 3.4% are now marginally above our 2014 year end target of 3.3%; 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 0.3% and 0.6%, respectively, significantly higher than current levels.

# BOND MARKET REVIEW

## Overseas government bonds

### Key points

- Continued weak eurozone inflation prompted the European Central Bank (ECB) to introduce further measures aimed at stimulating the eurozone economy, including a further cut in short term interest rates and an announcement of a programme of asset purchases.
- Employment data in the US remained firm, prompting discussion of earlier tightening of policy. This was highlighted at the September meeting of the Federal Open Market Committee, where the long term forecasts for the federal funds rate in 2017 were significantly higher at 3.75%.
- Easier monetary policy in both Europe and Japan led to the trade weighted dollar index rising by over 8% over the quarter.
- The hint of sovereign quantitative easing, by ECB president Mario Draghi at the Jackson Hole conference, led to a sharp outperformance of both semi-core and peripheral European debt; Spanish bonds outperformed by 0.20% over the quarter.

### Yield curve moves over the quarter

- 10 year government bond yields in the UK and Germany fell 0.25% and 0.30% respectively. The US and Japan lagged, with 10 year yields falling by less than 0.10% over the quarter.
- Longer dated bonds outperformed, particularly in the UK, where such moves were supported by pension fund demand following the "No" vote in the Scottish referendum.
- Shorter dated US government bond yields rose over the quarter, as stronger data led to the market pricing in a more bearish profile for the US federal funds rate.
- At the end of the quarter, 10 year conventional government bond yields in the US, Germany, Japan and the UK were 2.49%, 0.95%%, 0.53% and 2.42%, respectively.
- At the end of the quarter, 10 year real yields in the US, Germany and the UK were 0.51%, -0.52% and -0.47%.
- Weak energy prices and fears of large redemptions, following the resignation of Bill Gross from Pimco, led to breakeven (implied) inflation falling sharply over the quarter. At the end of the quarter, breakeven inflation rates in the US, Germany and the UK were 1.97%, 1.24% and 2.78%, respectively.

### Currency markets

- Over the quarter, the strength of sterling was unchanged against the basket of currencies in the indices, though volatility did pick up prior to the Scottish referendum.
- The largest moves were against the US dollar, where sterling depreciated by over 5% but was offset by a 2.5% appreciation relative to the euro and 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.
- 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 that the transition to greater fiscal and political unity will to volatile. Near term, however, the situation remains unpredictable.
- Given the low level of real yields, we expect a moderate rise from current levels, though this will be limited by anaemic global growth prospects and a broadly supportive backdrop for bonds.
- In the wake of a very deep recession, we do not see an immediate period of sustained inflation, unless economic growth turns out to be much faster than we expect. In the medium term, however, we see upside risks to inflation given the large amount of recent monetary and fiscal stimulus.
- We expect no change in rates from major central banks over the near term and, when they do rise, we expect them to plateau at a very low level compared with past standards.

# BOND MARKET REVIEW

## Global high yield bonds

### Key points

- Global high yield bonds (BofA Merrill Lynch BB-B Global Non-Financial High Yield Constrained Index, 100% hedged to sterling) returned -1.35% over the quarter. Monthly returns were volatile over this period (July -0.89%, August 1.28%, September -1.72%). Year to date, global high yield bonds have returned 4.36%.
- Real estate (1.09%) and autos (0.31%) sectors outperformed; energy (-3.60%) and retail (-2.06%) were relative laggards.
- Global new issuance in the quarter was over USD92 billion, down 13% on the same period last year and due primarily to a low level of issuance during August and September, owing to the weaker market. Year to date, issuance is only 4% versus this point last year, with issuance in the first half of 2014, particularly in Europe, making up for the weaker third quarter.
- The index yield ended the quarter 0.97% higher at 5.61%, with the average High Yield credit spread widening 0.79% to 4.13% above government bond yields. This spread is well above the all-time low of 1.96%, set in May 2007.

### Regions

- The US and Canada region returned -1.95% for the quarter (3.54% year to date). Credit spreads widened by 0.89% while underlying government yields were 0.28% higher. July and September exhibited the weakest performances.
- Europe returned -0.45% for the quarter and was the outperforming region (5.07% year to date). Credit spreads rose in the quarter, offset somewhat by lower government yields as the European Central Bank (ECB) continued to look at stimulating the eurozone economy (0.72% credit spreads and -0.17% underlying government yields).
- Emerging Markets was the weakest performing region, returning -2.12% in the quarter (5.19% year to date). This region showed a poor third quarter after a rebound in the second quarter, with spread widening accounting for virtually the entire move higher in yields (1.02% credit spreads and 0.04% underlying government yields).

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

### Monthly performance

- Benign markets in early July reflected solid US data, illustrated by strong payroll and employment figures. European markets grew wary of issues in relation to Banco Espirito Santo, which required a government recapitalisation. Performance was mainly driven by High Yield outflows; $10.2bn left US High Yield funds over July. Volatility was uncharacteristically high; the CDX HY index moved -0.8 points in one day, the worst move since 24 January. Nervousness in the markets persisted as Russia was subject to further sanctions and Argentina was reported to have missed a coupon payment.
- Volatility greeted August as markets digested the Banco Espirito Santo bailout plan, the Argentinean default and strong US data, and heavy fighting in Ukraine renewed geopolitical tensions. European markets grew cautious of weak quarterly GDP numbers. Performance was mainly driven by a stabilisation in High Yield fund flows. In the UK, the Bank of England's meeting minutes drove volatility in sterling, weakened by subdued inflation data but strengthened by the indication of dissent within the committee on rate hikes. US equities and European sovereign bonds stole the headlines at month end with the S&P500 exceeding 2,000 for the first time, and German, Spanish and Italian 10 year yields at historical lows.
- The ECB announced another cut of its main policy rate in September, and detailed future quantitative easing, with asset repurchases initially limited to asset backed securities and covered bonds. A fragile cease fire in Ukraine maintained geopolitical tensions. Market volatility greeted the Scottish independence referendum, with a majority voting to remain within the UK. Weak market technicals, such as the perception of gradually less accommodative US Federal Reserve (Fed) policies, sustained high issuance levels, low liquidity and low cash balances in funds, weighed on High Yield performance.

### Ratings & maturities

- For the quarter, BB rated bonds outperformed B rated bonds. BB and B rated bonds returned -0.57% and -2.22%, respectively, for the quarter. Outside of the benchmark index, the Global High Yield CCC & Lower index returned -3.90%, illustrating how positioning based upon higher credit rating had a significant impact on overall performance.
- Returns for the quarter were worse at longer maturities primarily due to spread widening. Returns were -0.36% for 0 to 3 years, -0.92% for 3 to 5 years, -1.26% for 5 to 7 years, -2.24% for 7 to 10 years and -1.73% 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 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 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.

# 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 the Bank of England 2% 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

- We expect global growth to be a little stronger in the second half of the year, principally due to stronger US growth, although the balance of risks, particularly those stemming from the eurozone and the geopolitical situation, are still on the downside. We expect global growth rates to remain lower than the pre-crisis average, capping the expected upside in policy rates and bond yields. Despite geopolitical tensions, benchmark crude oil prices have fallen, which should ease pressure on the global economy. However, there appears to be no likely near term source of "new demand" that would lift global growth rates materially.
- In our base case, average annual US GDP growth rises to 3% in 2015 from c.2% in 2014. Barring another sharp rise in mortgage rates, housing activity should continue to increase, and residential investment boost overall growth, over the year. Rising employment growth should support household demand.
- Eurozone growth has continued to disappoint. GDP was flat in the second quarter, with the downside news concentrated in Germany, France and Italy. Some of the weakness in Germany may have been down to erratic factors (weather). However, survey data in quarter three has given little indication of improvement. While the headline cost of capital is low, investment is constrained by weak expected demand and uncertainty over reforms, especially in economies such as Italy where structural change is most needed. We assume 1% growth in 2015, which takes into account support from a weaker euro and ECB stimulus.
- The UK economy grew by 0.9% in quarter two, and recent business surveys (including PMIs) suggest that positive momentum has continued into the second half of the year, although the manufacturing sector has been impacted by uncertainty in the eurozone. Overall, growth has been a little stronger than we expected, mid-year. Looking ahead into 2015, our base case assumes growth is supported by household and business spending over the forecast period, rather than net trade and government spending. Employment growth and hours worked should also underpin incomes and consumer sentiment. We 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 GDP growth to be less than the official target of 7.5%. The economy faces three headwinds: the impact of anti-corruption measures, the aftermath of a credit bubble, and a slow rebalancing from trade and investment towards consumer demand. The rapid growth in credit, and the vulnerabilities associated with the property sector, remains the key risk to the immediate outlook. 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 the effect of higher consumption taxes take effect.

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

- UK consumer price inflation (CPI) fell to 1.5% in August, in part due to the latest supermarket price war and stronger sterling. We assume a gradual firming in wage growth, as the labour market tightens, and a waning currency effect, will keep CPI close to 2% in 2015. We expect house price inflation and rising interest rates to boost retail price inflation relative to CPI.
- A period of "emergency" monetary policy has yet to create robust growth conditions, and we expect only a marginal policy tightening in the UK and US in 2015. Global economic headwinds remain, with the balance of global savings and investment flows requiring lower interest rates in the medium term. We assume a gradual profile of rate increases, to a level much lower than in previous rate cycles. Central banks will likely have an asymmetric view of inflation risk, following the financial crisis, while levels of public and private debt have raised the economic sensitivity to changes in the cost of money.

## 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 Bank of England. 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 approximately 1.25% p.a. over the next three years.

# CORPORATE GOVERNANCE & COMPLIANCE

## MiFID (Markets in Financial Instruments Directive)

- Pursuant to the FCA rules and based on information that we hold about you, we have classified you a 'Professional Client'.

## Whistleblowing requirements of the Pensions Act

- We confirm that we have not made any reports to the Pensions Regulator during the quarter, as we do not believe there has been a breach of law relevant to the administration of the scheme.

## The UK Stewardship Code & Royal London Asset Management

- 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

**Jonathan Platt**
Head of Fixed Interest

**Paola Binns**
Credit Fund Manager

### Your dedicated contact

**James Stoddart**
Head of Client Account Management

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

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|---|---|---|
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### Fixed interest team changes

George Henderson, one of the managers within RLAM's Government Bond team, has decided to return to New Zealand to take up the running of his family's farm. We wish George well in his new venture and thank him for his dedication and expertise over the ten years he has been at RLAM.

### Distribution team changes

Within Client Account Management we said goodbye to Lorraine Meighan after 9 years at RLAM and we welcomed Amanda Dolan to the team to the new role of Client Service Manager.

# 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.

# Portfolio Valuation

As at 30 September 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** | | | | | | | | | |
| | 137,458,611 | RLPPC Over 5 Year Corp Bond Pen Fd | 1.90067 | 171,902,310.91 | 261,263,457.84 | 0.00 | 261,263,457.84 | 0 | 100.0 |
| | | | **Funds Held total** | **171,902,310.91** | **261,263,457.84** | **0.00** | **261,263,457.84** | | **100.0** |
| | | | **Grand total** | **171,902,310.91** | **261,263,457.84** | **0.00** | **261,263,457.84** | | **100.0** |

# Trading Statement

For period 01 July 2014 to 30 September 2014

## Dorset County Pension Fund

### Acquisitions

**Funds Held**

| Trade Date | Transaction Type | Nominal | Security | Price (£) | Book Cost (£) |
|---|---|---|---|---|---|
| 03 Jul 2014 | Acquisition | 5,424,729.17 | RLPPC Over 5 Year Corp Bond Pen Fd | 1.84 | 10,000,000.00 |
| 07 Jul 2014 | Acquisition Rebate | 82,003.04 | RLPPC Over 5 Year Corp Bond Pen Fd | 1.85 | 151,409.59 |
| 11 Sep 2014 | Acquisition | 170,458.67 | RLPPC Over 5 Year Corp Bond Pen Fd | 1.91 | 325,027.18 |
| 19 Sep 2014 | Acquisition | 20,970,405.52 | RLPPC Over 5 Year Corp Bond Pen Fd | 1.91 | 40,000,000.00 |
| | | | | **Funds Held total** | **50,476,436.77** |
| | | | | **Acquisitions total** | **50,476,436.77** |