Insight
INVESTMENT

DORSET LIABILITY MATCHING PORTFOLIO

For the period
01 July 2014 to 30 September 2014

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Investment Summary

DORSET LIABILITY MATCHING PORTFOLIO

For the period 01 July 2014 to 30 September 2014

Summary of Performance

Performance summary to 30 September 2014

	3 Months (%)	1 Year (%)	Since Inception (%)
Portfolio	3.62	7.62	18.93
Benchmark	4.10	5.36	16.75
Relative Return	-0.48	2.27	2.19

	3 Months (£)	1 Year (£)	Since Inception (£)
Portfolio	7,124,342	14,438,085	58,730,928
Benchmark	8,056,115	10,361,020	51,921,496
Relative Return	-931,773	4,077,066	6,809,432

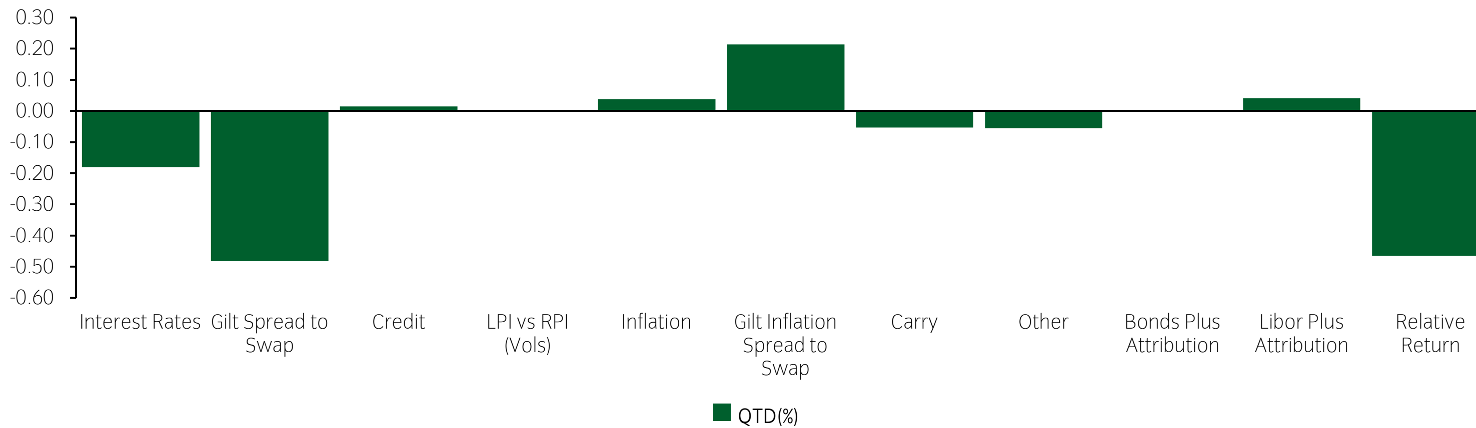
Source: Insight Investment

Inception date for performance purposes: 31 October 2012

Any footnotes relate to the current quarter-end; historic footnotes available on request

LDI Attribution

Quarter-to-date relative percentage attribution



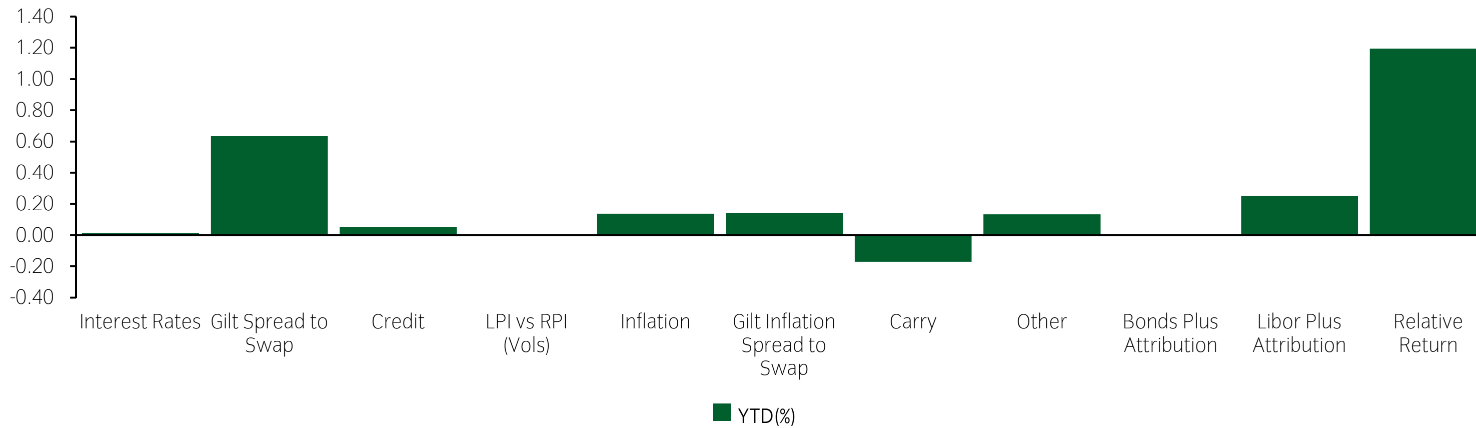
Description	QTD (%)
Interest Rates	-0.18
Gilt Spread to Swap	-0.48
Credit	0.01
LPI vs RPI (Vols)	0.00
Inflation	0.04
Gilt Inflation Spread to Swap	0.21
Carry	-0.05
Other	-0.06
Bonds Plus Attribution	0.00
Libor Plus Attribution	0.04
Relative Return	-0.46

Note: The percentage attributes and returns are calculated geometrically, and therefore the relative return may differ to the arithmetic percentage return shown on the returns summary page.

All figures are calculated geometrically

LDI Attribution

Year-to-date relative percentage attribution



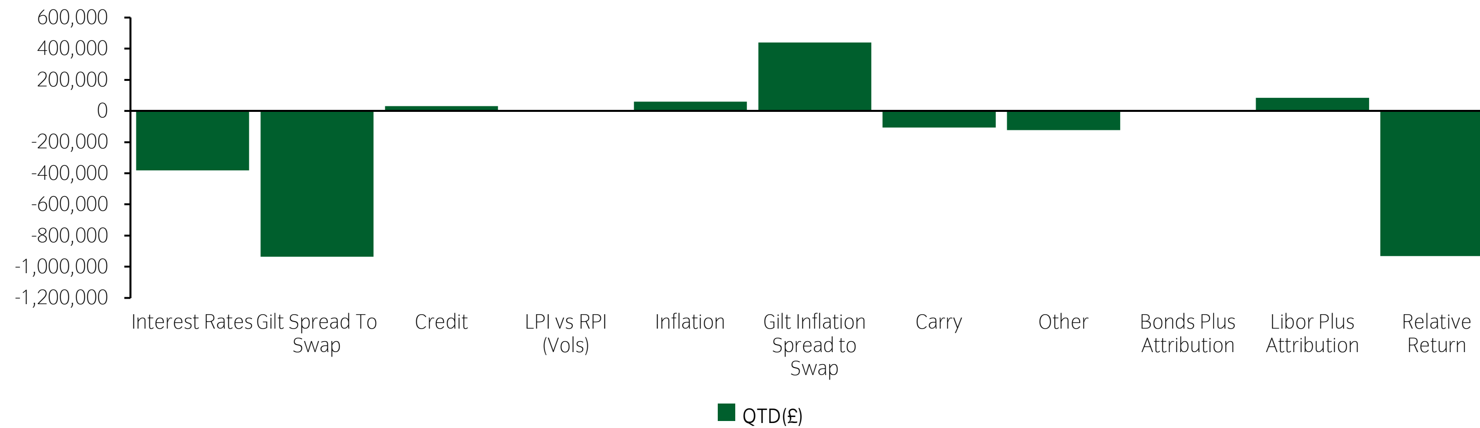
Description	YTD (%)
Interest Rates	0.01
Gilt Spread to Swap	0.63
Credit	0.05
LPI vs RPI (Vols)	0.00
Inflation	0.14
Gilt Inflation Spread to Swap	0.14
Carry	-0.17
Other	0.13
Bonds Plus Attribution	0.00
Libor Plus Attribution	0.25
Relative Return	1.20

Note: The percentage attributes and returns are calculated geometrically, and therefore the relative return may differ to the arithmetic percentage return shown on the returns summary page.

All figures are calculated geometrically

LDI Attribution

Quarter-to-date relative monetary attribution

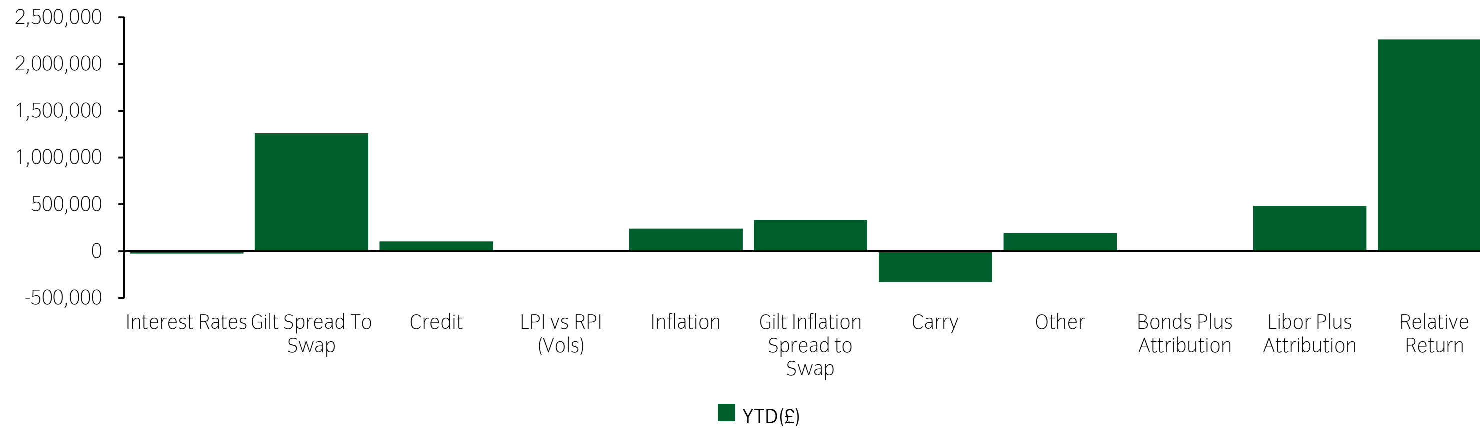


Description	QTD (£)
Interest Rates	-380,689.37
Gilt Spread To Swap	-935,843.74
Credit	30,119.35
LPI vs RPI (Vols)	0.00
Inflation	59,446.46
Gilt Inflation Spread to Swap	439,957.72
Carry	-106,976.46
Other	-122,465.60
Bonds Plus Attribution	0.00
Libor Plus Attribution	84,678.68
Relative Return	-931,772.98

All figures are calculated geometrically

LDI Attribution

Year-to-date relative monetary attribution

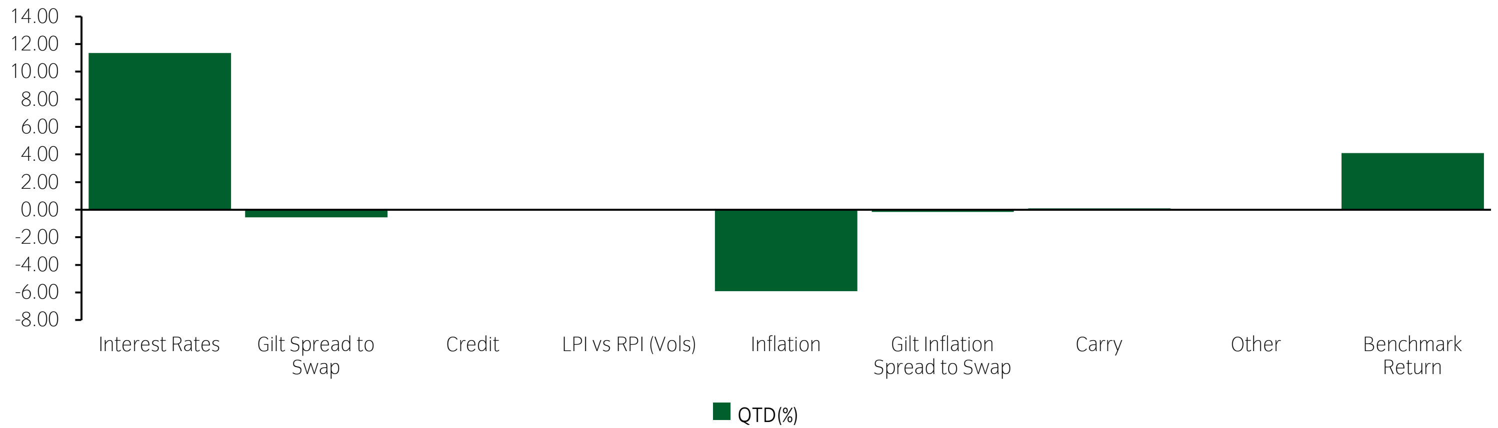


Description	YTD (£)
Interest Rates	-26,223.79
Gilt Spread To Swap	1,260,482.20
Credit	104,447.63
LPI vs RPI (Vols)	0.00
Inflation	241,446.05
Gilt Inflation Spread to Swap	333,551.17
Carry	-330,562.53
Other	194,183.56
Bonds Plus Attribution	0.00
Libor Plus Attribution	485,932.92
Relative Return	2,263,257.21

All figures are calculated geometrically

LDI Attribution

Quarter-to-date benchmark percentage attribution



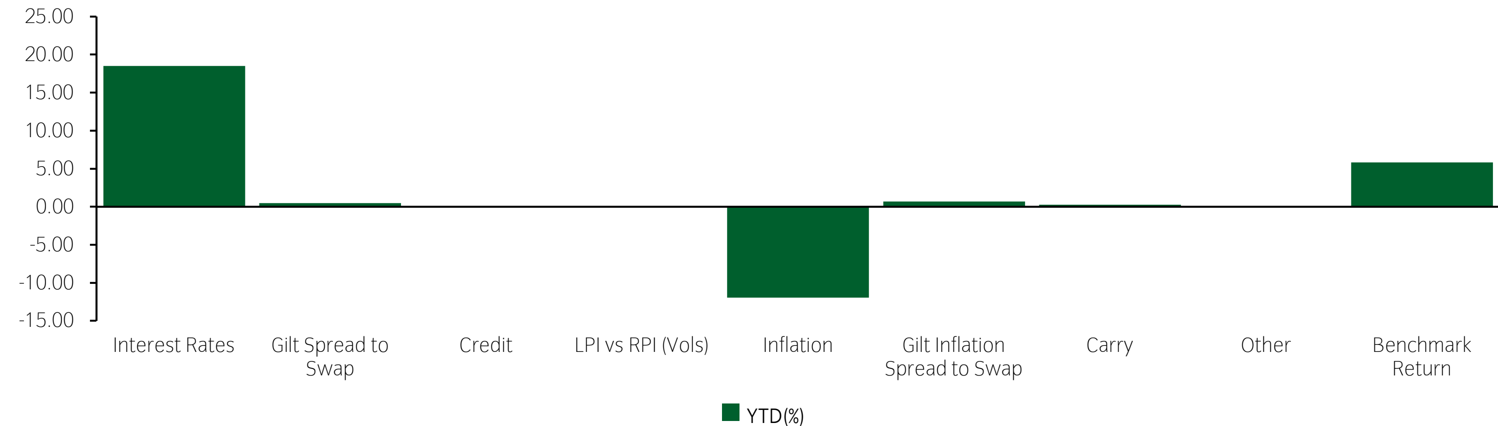
Description	QTD (%)
Interest Rates	11.36
Gilt Spread to Swap	-0.55
Credit	0.01
LPI vs RPI (Vols)	0.00
Inflation	-5.91
Gilt Inflation Spread to Swap	-0.17
Carry	0.09
Other	-0.03
Benchmark Return	4.10

Note: The percentage attributes and returns are calculated geometrically.

All figures are calculated geometrically

LDI Attribution

Year-to-date benchmark percentage attribution



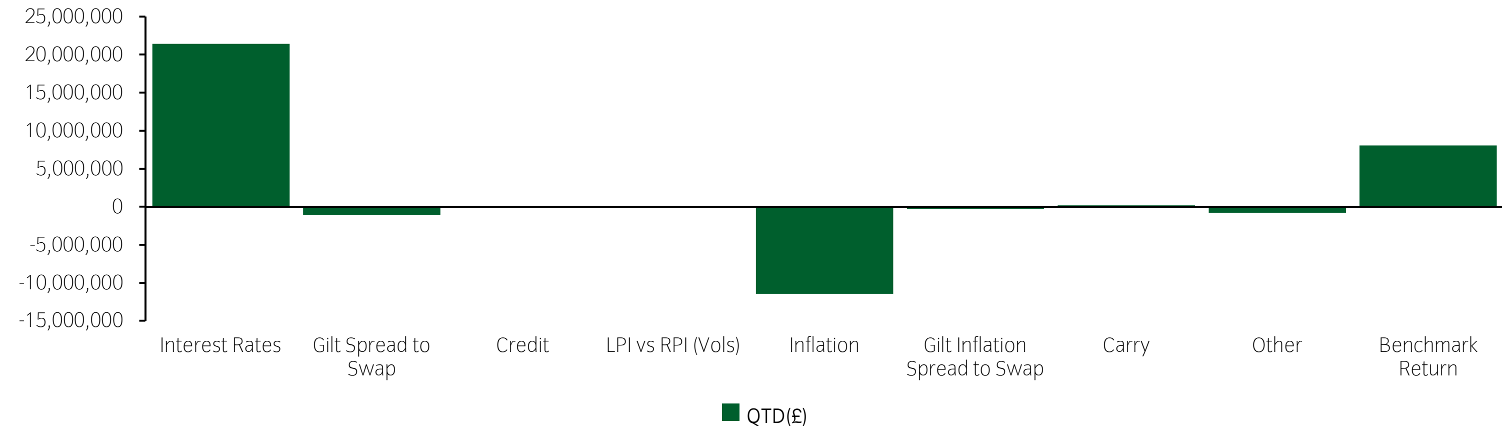
Description	YTD (%)
Interest Rates	18.48
Gilt Spread to Swap	0.46
Credit	0.01
LPI vs RPI (Vols)	0.00
Inflation	-11.95
Gilt Inflation Spread to Swap	0.67
Carry	0.26
Other	0.02
Benchmark Return	5.80

Note: The percentage attributes and returns are calculated geometrically.

All figures are calculated geometrically

LDI Attribution

Quarter-to-date benchmark monetary attribution

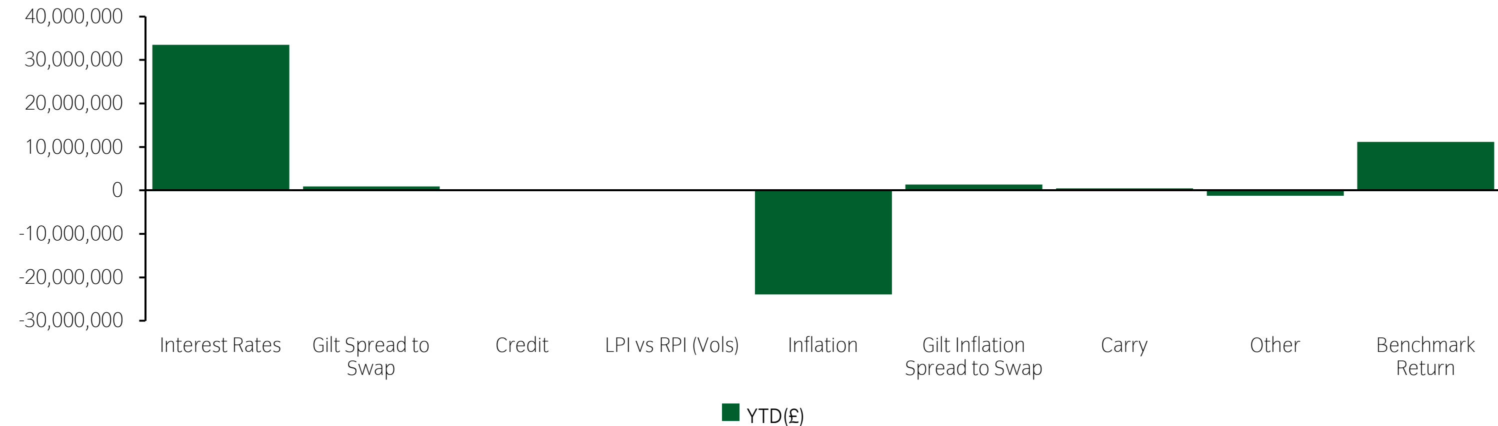


Description	QTD (£)
Interest Rates	21,416,877.10
Gilt Spread to Swap	-1,067,431.79
Credit	25,770.15
LPI vs RPI (Vols)	0.00
Inflation	-11,439,479.29
Gilt Inflation Spread to Swap	-291,366.39
Carry	179,119.39
Other	-767,374.53
Benchmark Return	8,056,114.65

All figures are calculated geometrically

LDI Attribution

Year-to-date benchmark monetary attribution

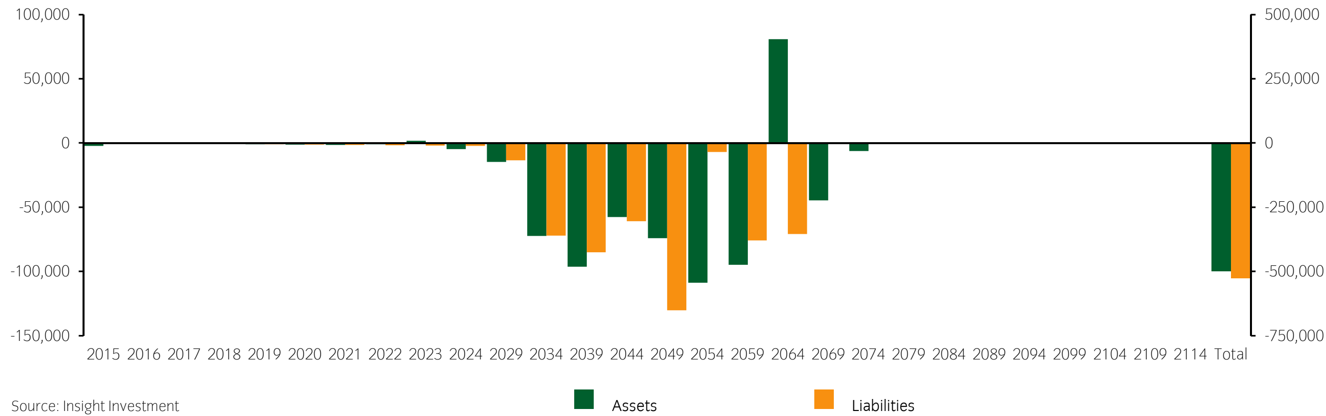


Description	YTD (£)
Interest Rates	33,514,238.72
Gilt Spread to Swap	917,663.13
Credit	19,257.90
LPI vs RPI (Vols)	0.00
Inflation	-23,888,399.20
Gilt Inflation Spread to Swap	1,344,449.48
Carry	501,666.09
Other	-1,233,905.00
Benchmark Return	11,174,971.13

All figures are calculated geometrically

LDI Analysis

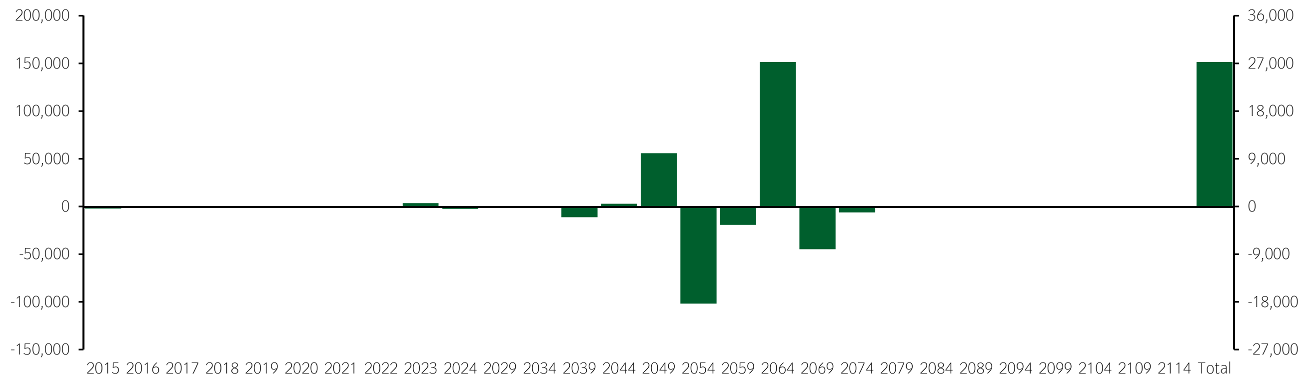
Interest Rate Risk (PV01)
Assets vs Liabilities (£)



Source: Insight Investment

Interest Rate Sensitivity (PV01): The change in the present value of the scheme assets or liabilities resulting from a 0.01% (one basis point) parallel upward shift in the discount curve.

Current Portfolio vs Liabilities (£)



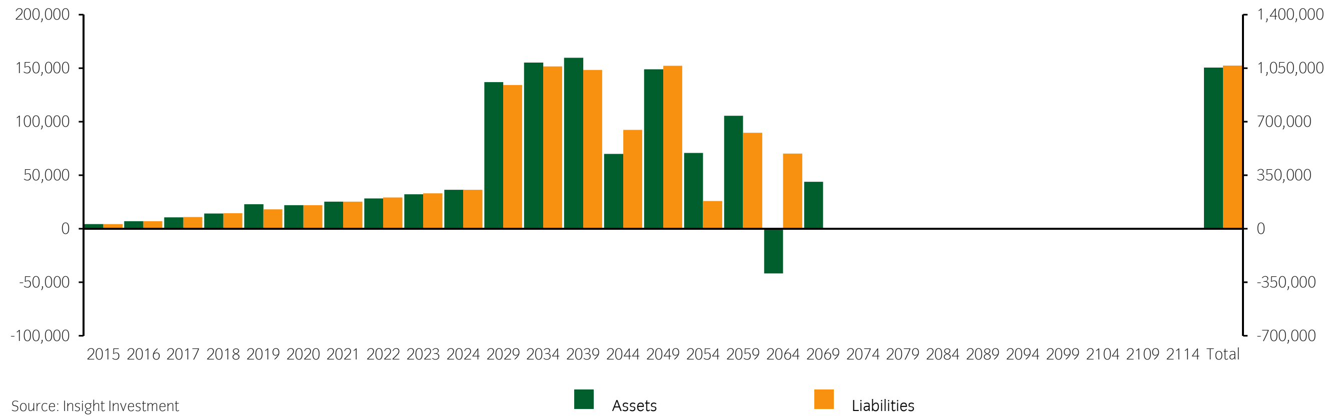
Source: Insight Investment

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

LDI Analysis Continued

Inflation Risk (IE01)

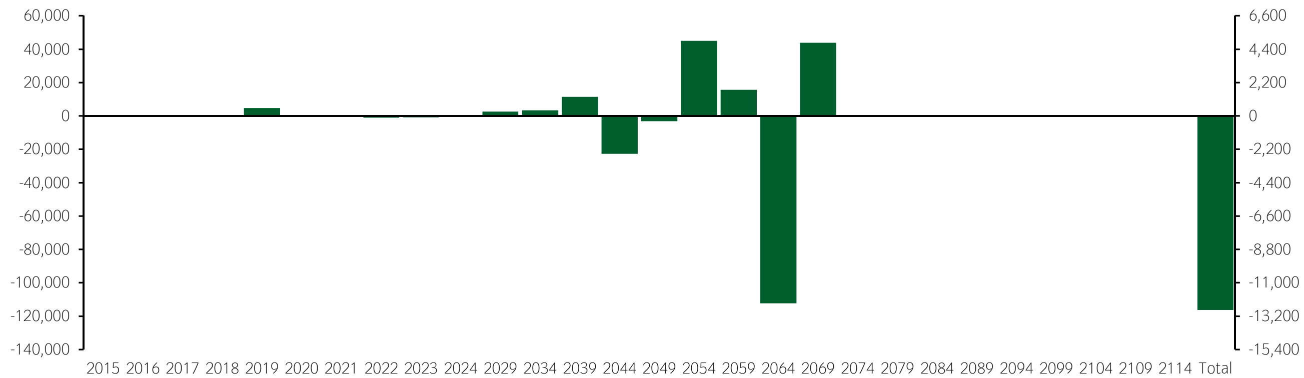
Assets vs Liabilities (£)



Source: Insight Investment

Inflation Sensitivity (IE01): The change in present value of the inflation-linked schemes assets or liabilities resulting from a 0.01% (one basis point) parallel upward shift in the inflation expectation curve.

Current Portfolio vs Liabilities (£)



Source: Insight Investment

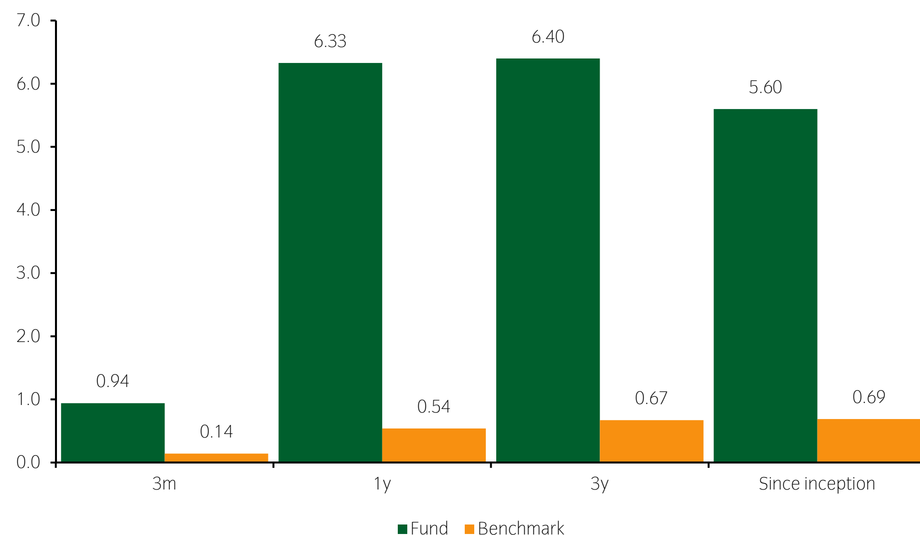
Note: Liability benchmark sensitivities will equal asset sensitivities where no liability benchmark is available

Insight Investment Funds

DORSET LIABILITY MATCHING PORTFOLIO

Libor Plus Fund

Fund performance as at 30 September 2014



Benchmark refers to 3 month sterling LIBOR. Source: Insight Investment. Performance of the Fund is on an offer basis with income reinvested and gross of management charge. Performance for periods over one year is annualised

Fund Manager Comments

The Fund outperformed its benchmark during the third quarter of 2014. The running carry remained strong at Libor +173bps. The asset-backed securities (ABS) market began the quarter solidly but soon softened in sympathy with the volatility seen outside the asset class. Escalation in the conflict in Ukraine, as well as Argentina missing an interest payment on their debt resulted in significant moves wider in higher-beta credit and within the ABS market, collateralised loans obligations (CLOs) came under particular pressure. The trend reversed at the end of August on a combination of improved economic flows, the stabilisation of the political situation between Russia and Ukraine and rumours of an early quantitative easing programme by the European Central Bank (ECB) through the ABS market. September saw a significant tightening of spreads in the ABS market, contrary to the weakness experienced in the broader risk markets, as the ECB confirmed that it would be buying selected ABS with a broad-ranging and sizeable purchase programme. Against this background, many parts of the ABS performed strongly, with the largest moves seen in peripheral eurozone ABS. New supply was subdued over the summer, but of note was the issuance of retention-compliant US deals in both the commercial mortgage-backed securities (CMBS) and CLO markets that are structured to meet EU requirements in order to attract European investors.

Libor Plus Fund Continued

We participated in some of these US deals as a way to diversify and to pick up incremental yield at the front end of the curve. September was a heavy issuance month with a number of collateralised loan obligation deals pricing at the tightest levels seen so far in 2014. Issuance was also seen from the residential mortgage-backed securities (RMBS) markets in the UK and the Netherlands with a mixture of transactions making their way to market. The main Fund activity over the quarter was the continuing reduction of our UK non-conforming position as the prepayment option we have been buying becomes more fully priced. Against this, we have continued to increase our position in collateralised loan obligations as we believe this remains the cheapest asset class in credit on a risk-adjusted basis. We also began to unwind our peripheral eurozone positions as we believe the risk/return profile is now more balanced. Instead, we prefer to add RMBS in Australia and CMBS in the US. We continue to have a stable outlook over the medium term and continue to believe that the long term strategic value of the asset class remains strong.

Libor Plus Fund Continued

Credit Rating Breakdown of Non-Government Positions

AAA	55.0
AA	45.0

Maturity Profile (in weighted average life, %)

Less than 0.5 years	6.8
0.5 to 1 year	1.2
1 to 1.5 years	3.5
1.5 to 2 years	9.2
2 to 3 years	12.7
3 to 4 years	31.9
4 to 5 years	13.6
5 to 6 years	21.1

Jurisdiction (% of Fund)

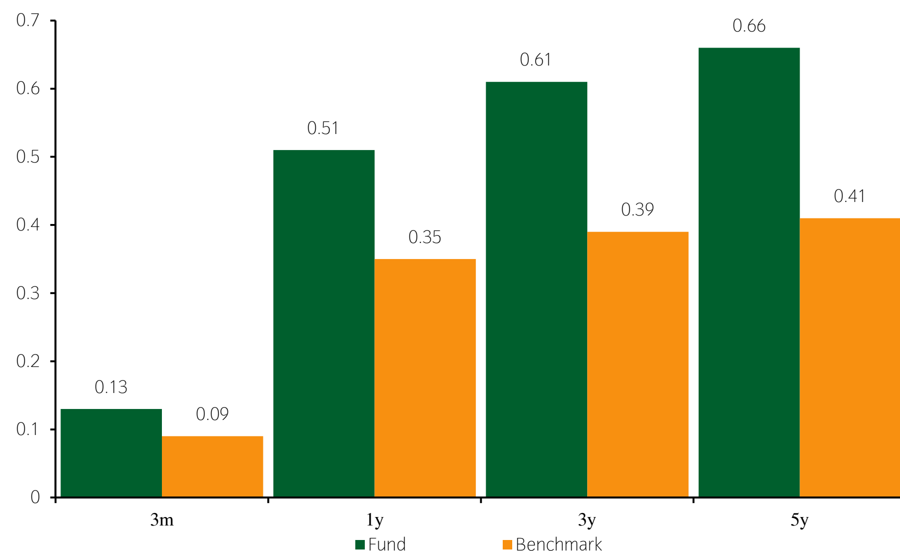
UK	25.1
Netherlands	5.3
US	10.3
Germany	1.1
Spain	5.4
Italy	3.2
Ireland	1.6
Portugal	1.6
France	0.9
Sweden	0.8
Pan-Europe	17.0
Norway	0.2
Belgium	0.0
Australia	20.6
Cash	6.8

Asset Backed Securities (% of Fund)

Prime RMBS	53.4
Consumer	0.2
Buy to Let	0.7
Leveraged Loan CLO	21.2
SME CLO	3.0
CMBS	9.8
Cash	6.8
UK Non-conforming RMBS	4.9

Insight Liquidity Sterling Fund

Fund performance as at 30 September 2014



Benchmark refers to 7 Day GBP Libid. Source: Insight Investment. Basis: Performance over 1 year is annualised, gross of all fees and expenses.

Fund Manager Comments

The Fund returned 0.13% over the quarter gross of fees, outperforming its benchmark, 7-day sterling Libid, which returned 0.09%. The Fund's duration and yield curve positioning were positive for returns relative to the benchmark. Trading focused largely on highly liquid, short-dated securities. The Fund primarily made additions to the certificates of deposit and commercial paper portfolio from bank issuers, incrementally adding to issues from institutions like Dexia, Nordea, SEB and the Bank of Tokyo-Mitsubishi. Towards the end of the quarter, the Fund also incrementally added collateralised commercial paper issued by JPMorgan. The weighted average maturity of the Fund was 36 days at the beginning of the quarter and rose to 46 days by the end of the period.

Insight Liquidity Sterling Fund Continued

Fund Breakdown by Asset Class

Certificates of deposit	27.9
Commercial paper	4.8
Corporate floating rate	33.1
Mortgage-Backed	16.1
Asset-Backed	0.8
Money Market Fund	7.4
Supranational	2.4
Sovereign Fixed Rate	7.5

Top 10 holdings

Call Account Lloyds	9.0
UK Bonds 5.00% 07.09.2014	3.2
Repo Merrill Lynch 0.42% 26.08.2014	2.8
Repo Societe Generale 0.43% 29.08.2014	2.8
Repo HSBC 0.20% 29.08.2014	2.8
Repo Toronto-Dominion Bank 0.30% 29.08.2014	1.8
TD Australia and New Zealand Bank 0.30% 01.09.2014	1.4
Repo Barclays Bank 0.30% 29.08.2014	1.4
Z/C CP Nederlandse Waterschapsbank 28.11.2014	1.3
FRN Rabobank Nederland 14.11.2014	1.1

Credit Rating Breakdown

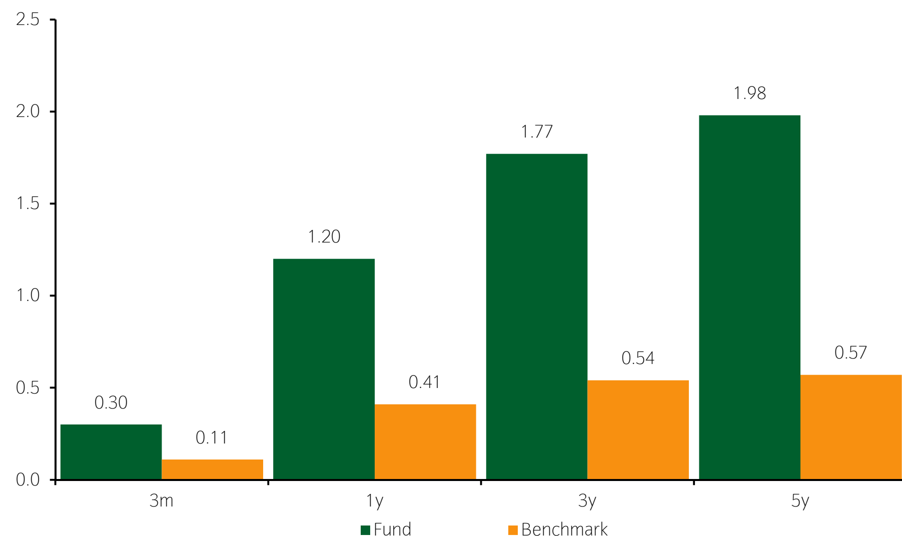
A1+	75.6
A1	24.4

Maturity Profile

1 day	31.6
2-7 days	2.1
8-30 days	13.9
31-90 days	32.2
91-180 days	19.2
181 days +	1.1

Insight Liquidity Sterling Plus Fund

Fund performance as at 30 September 2014



Benchmark refers to 3 Month GBP Libid. Source: Insight Investment. Basis: Performance over 1 year is annualised, gross of all fees and expenses.

Fund Manager Comments

The Fund returned 0.30% over the quarter gross of fees, outperforming its benchmark, 3-month sterling Libid, which returned 0.11%. Asset allocation was positive for returns over the quarter as a result of positive carry and rolling over floating rate notes. In terms of activity, we added several names to holdings, including issues from Bank of Tokyo-Mitsubishi, DNB, Danske Bank, French institution BPCE, German banks Helaba and DZ, BNP Paribas and Dexia. In this portfolio, we also bought issues from Citi in Swiss francs, Mizuho in euros and Nordea in Norwegian and Danish krone, and fully hedged them in order to achieve better sterling returns. In the floating rate notes portfolio we added issues from Credit Suisse, the European Investment Bank, Commonwealth Bank of Australia, Royal Bank of Canada, General Electric, Westpac and New Zealand bank ASB. In asset-backed securities, spreads remained tight. We bought some new issues over the quarter, including Paragon, Oak, Delamare, Gosforth Funding and Resimac. We continued to trade short-dated gilts over the period. The weighted average maturity of the Fund began the quarter at 52 days, and stood at 73 days at the end of the quarter.

Insight Liquidity Sterling Plus Fund Continued

Fund Breakdown by Asset Class (% of Fund)

Certificates of deposit	40.4
Commercial paper	25.3
Corporate Bond	0.2
Corporate floating rate	2.5
Government Bond	2.6
Repurchase Agreement	13.4
Supranational	0.1
Time deposits	15.6

Top 10 holdings (% of Fund)

Insight Liquidity GBP Fund	7.4
UK Bonds 23.03.2015	3.2
Z/C CD La Banque Postale 27.11.2014	2.4
FRN GE Capital 09.05.2016	2.0
MBS Perm Master Issuer 2.21% 15.07.2042	1.7
FRN Commonwealth Bank of Australia 22.07.2016	1.6
FRN Westpac Securities 02.10.2017	1.6
CD Banques Populaires Caisses D'Epargne 0.75% 09.03.2015	1.6
CD Landesbank Hessen-Thueringen Girozentrale 1.10% 17.07.2015	1.6
CD Landesbank Hessen-Thueringen Girozentrale 1.08% 17.09.2015	1.6

Credit Rating Breakdown (% of Fund)

AAA	22.5
AAA-	4.1
AA+	4.1
AA	0.1
AA-	13.0
A+	2.4
A	7.3
A-1+	18.9
A-1	27.8

Maturity Profile (% of Fund)

1 year	54.2
1-3 years	23.0
3-7 years	8.1
7-10 years	0.0
10+ years	14.8

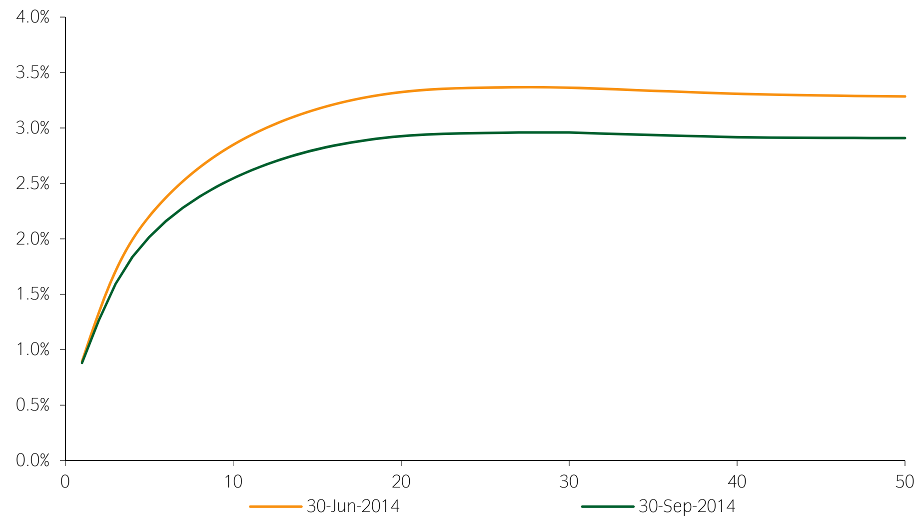
Investment Analysis

DORSET LIABILITY MATCHING PORTFOLIO

For the period 01 July 2014 to 30 September 2014

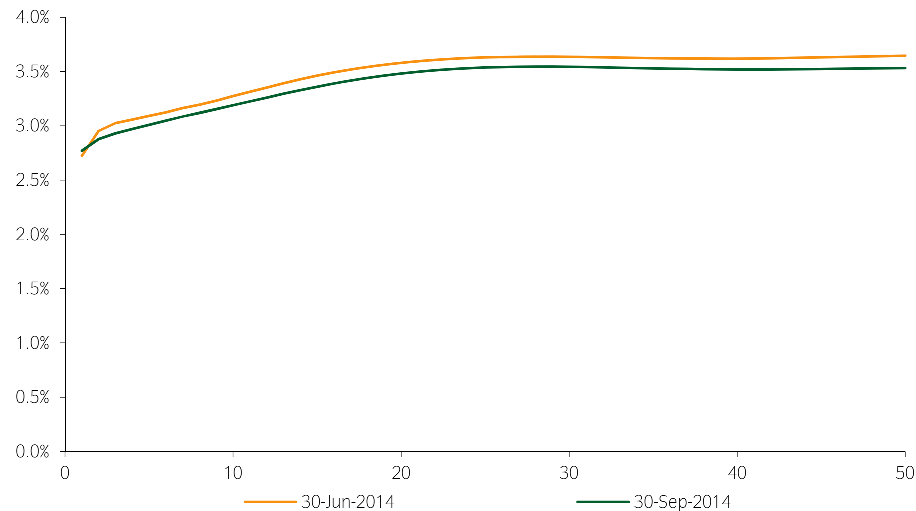
Sterling LDI

Interest rate swap rates (%)



Source: Xenomorph broker quotes composite

RPI swap rates (%)



Source: Xenomorph broker quotes composite

Market review

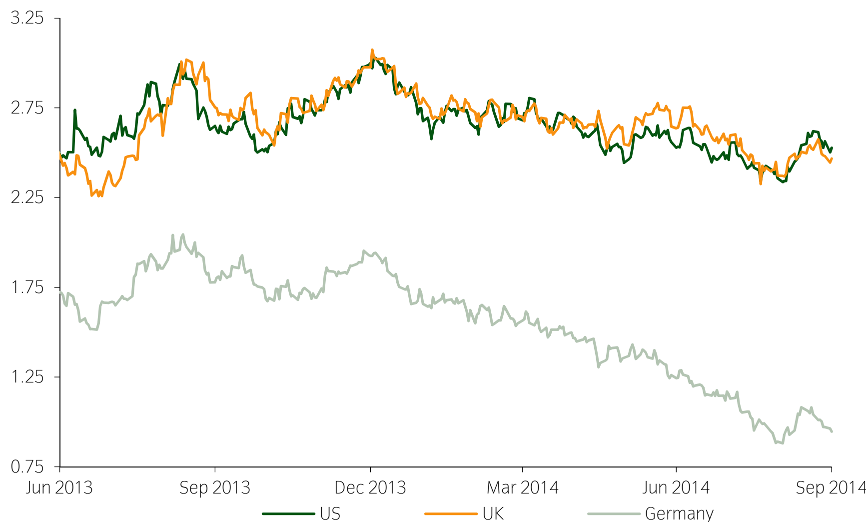
- International events weighed heavily on market sentiment; ongoing geopolitical instability in both the Ukraine and the Middle East drove a general "flight to quality" which pushed gilt yields lower.
- Attention turned to Scotland in the run up to September's Referendum. Polls giving credence to the possibility of a 'Yes-vote' pushed back market consensus on the timing of the first rate hike, causing the gilt curve to steepen.
- In the aftermath of the 'No-vote', the gilt curve flattened as short-term rates rose and long-term rates fell.
- Central Bank action, realised and anticipated, was a significant source of focus. The European Central Bank further cut benchmark interest rates and deposit rates to 0.05% pa and -0.2% pa respectively.
- The 2032 conventional gilt z-spread fell by c.0.02%. Index-linked gilt z-spreads rose by c.0.02% across the curve, with slightly larger moves at the long end of the curve. The 2042 linker z-spread finished the quarter at 0.23%.
- Real swap rates fell across the curve, with the 20 year rate finishing the quarter at -0.53%. Nominal interest rates also decreased over the quarter higher, with the 20 year point declining 0.40% over the quarter to 2.93%. The RPI swap rate curve moved similarly; the 20 year rate fell by 0.10% to 3.48%.

Fixed Income Market Review

UK

UK gilt markets, both conventional and index-linked, performed strongly over the third quarter of 2014. During July, yields fell mainly due to geopolitical events. Comments from policy makers suggested that monetary policy was likely to remain accommodative for the immediate future. Yields retraced some of their gains in September. Overall for the quarter, yields fell significantly across the curve, with gilts maturing in 15 years or longer experiencing yield drops of between 35-38bps.

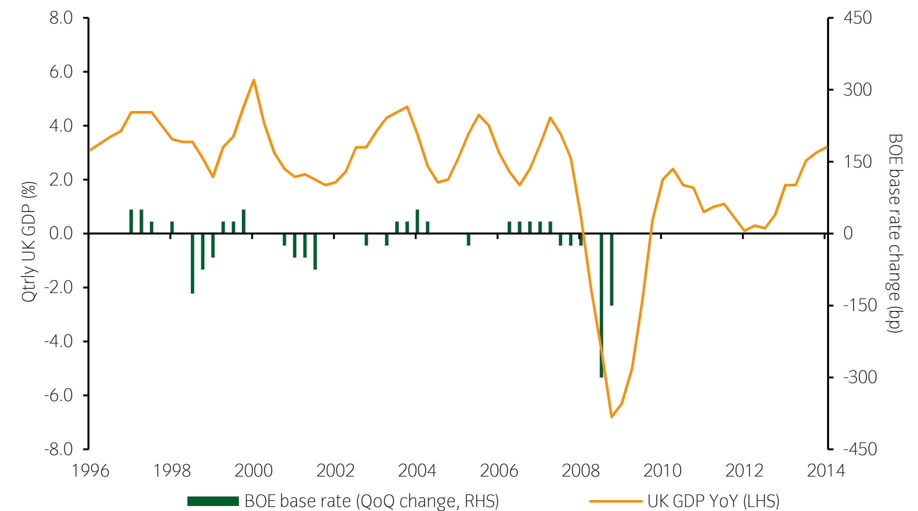
Chart 1: US, UK and Germany government bonds: 10 year yields (%)



Source: Bloomberg

The Monetary Policy Committee (MPC) maintained the base rate at 0.5% throughout the period. However, there was a significant change in the balance of views in the committee, with two members voting in favour of raising interest rates, saying that the health of the economy was sufficient to justify an immediate rise in the bank rate. Separately, the Bank of England (BOE) raised its growth forecasts for the UK economy to 3.5% in 2014 and to 3% in 2015 in its quarterly inflation report. Still, BOE governor Mark Carney said that weak wage growth reflected a greater degree of economic slack than implied by rapidly falling unemployment levels. The BOE lowered its forecast for wage growth in 2014 to 1.25%. Price pressures abated over the period, as the rate of consumer-price growth slowed to 1.5% in August from 1.9% in June. Economic growth in the UK was somewhat uneven as manufacturing sector activity continued to slow while activity in the services sector expanded at the fastest pace in nearly a year and the construction sector continued its strong recovery.

Chart 2: UK economic activity



Source: Bloomberg, as at 30 September 2014

Fixed Income Market Review Continued

Europe ex UK

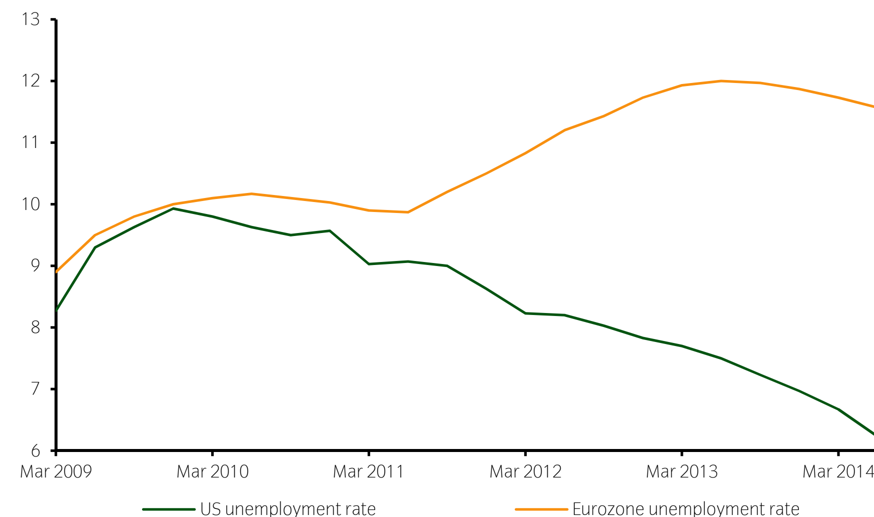
European government bonds, both core and peripheral, rallied over the third quarter of 2014 as the eurozone economy continued to struggle and the market increased its conviction that the European Central Bank (ECB) would be forced to act again, which it did in early September.
Eurozone GDP stagnated in the second quarter, with positive growth in countries such as Spain and the Netherlands failing to offset the torpor of the bloc's three largest economies: Germany's economy registered a surprise contraction in the second quarter, Italy fell back into recession while France's economy stagnated. Concerns over the potential for deflation remained as the annual rate of inflation in the eurozone dropped to 0.3%, the lowest level in almost five years, a fraction of the ECB's goal of just under 2%.

Against this backdrop, the ECB reduced the benchmark interest rate to a record-low of 0.05% and the deposit rate to -0.20% while outlining details around its plan to purchase covered bonds and asset-backed securities in the fourth quarter of 2014, starting with covered bonds in the second half of October. The bank also gave more information on its targeted longer-term refinancing operations (TLTRO), a programme to support bank lending to the real economy.

The increasingly dovish ECB heightened market speculation that it could be inching toward a broad-based quantitative easing programme, similar to the programmes implemented by the US and UK central banks, to include the purchase of government bonds. This encouraged a further rally in core government debt, particularly Germany. Germany's benchmark 10-year government bond yield fell below 1% while two-year yields turned negative. Yields on short-dated debt in France, Finland, Belgium and the Netherlands also moved into negative territory.

While yield spreads between German bunds and other Eurozone government bonds narrowed over the quarter, Spanish and Italian government debt staged a particularly strong rally, despite suffering a temporary wobble after it became apparent Portugal's biggest lender, Banco Espirito Santo, required a state rescue.

Chart 3: US and European divergence in labour trends (%)



Source: Bloomberg. GDP forecasts are based on contributor composites. As at September 2014.

US

US treasury yields fell during July and August, mainly on geopolitical concerns and slightly weaker-than-expected US job growth figures. In the midst of this newsflow, generally solid US economic data was largely ignored. The situation reversed in the second half of September and yields moved higher across the curve with the US front-end marking year-to-date highs. The benchmark 10-year yield ended the period little changed at 2.48%.

The world's largest economy staged a stronger-than-expected rebound in the second quarter as US GDP advanced at an upwardly revised annualised rate of 4.6%, according to a final estimate. US job growth rebounded in September and the jobless rate fell below 6% for the first time since mid-2008. The Federal Reserve (Fed) reduced its monthly bond buying programme to $15 billion over the quarter, keeping the central

Fixed Income Market Review Continued

bank on course to end the quantitative easing programme in October. Fed chair Janet Yellen said that while the Fed remains committed to keep interest rates near zero for a considerable amount of time, its view could change if US economic performance continued to exceed expectations. Yellen added that the labour market remains in focus, noting that a range of labour-market indicators continue to suggest significant underutilisation of labour resources. US inflation pressures remained contained at 1.5% over the quarter, driver lower by falling energy prices.

Emerging market debt

Emerging market debt (EMD) had a turbulent quarter amid a confluence of geopolitical and economic developments. Local government emerging market yields ranged from 6.45% to 6.78%. A raft of strengthening US economic data over the period pushed Treasury yields higher and sparked a rally in the US dollar, resulting in a selloff focused on emerging market assets. The crisis in Ukraine continued to escalate as tit-for-tat sanctions between Russia and the West served to undermine confidence, while unrest in the Middle East became more entrenched. Heavy outflows from US high yield mutual and exchange-traded funds reinforced the negative sentiment as did Argentina's technical default on its New York jurisdiction bonds.

Emerging market debt received a temporary reprieve in August, however, as US high yield fund flows stabilised, snapping a run of record outflows. While this spurred a fresh wave of investor demand for yield, it proved to be short-lived, as emerging market assets came under renewed pressure following a set of disappointing economic releases from China, softening commodity prices and mixed signals from the Fed in regard to potential US treasury yield normalisation.

Loans

The third quarter of 2014 was a more volatile period for loans, albeit driven mainly by wider technical issues. The selloff in the US high yield market had a knock-on effect on the loan market, with global hedge funds forced to sell loans to meet redemptions in an increasingly illiquid high yield market. Nevertheless, primary issuance remained firm. July saw a level of issuance not seen since 2007, with 39 transactions launched, totalling €14.6bn. There were a number of larger deals, with a total of €2.9bn in loans for European private hospital operators Generale de Sante and Quiron. Over the quarter European primary issuance volumes reached €20bn which was less than the €30bn seen during the second quarter, but still supportive of a strong year-end volume.

Another trend of note was a pick-up in leverage from 4.6x at the end of the second quarter to 5.0x by the end of the third quarter. In addition, defaults edged up to 5.8% from 5.1%, emphasising the need for careful stock selection. There were also some aggressive and/or weak businesses that initially came to the market, but in the face of the market choppiness had to make their offerings more favourable in order to get them away. There have been some benefits to this volatility, namely that investor appetite is a bit more muted compared to the first half of the year, with the trend for tighter pricing abating somewhat.

Investment Grade Credit

The rally in credit markets started to fade in the third quarter as investors became more concerned over the prospects of rising interest rates. Investment grade corporate bonds produced a positive return whilst high yield ended in negative territory. Lower-beta sectors such as utilities and telecommunications performed strongly.

In terms of fundamentals, global corporate defaults remained at historically low levels: 43 for this year until August versus 58 last year for the same time period. Conversely, two major corporate defaults made the headlines this quarter: the Portuguese lender Banco Espirito Santo and the bankruptcy of Phones 4u in the UK. The latter was a painful reminder that highly leveraged companies have little tolerance to event risk. According to Moody's, August saw the number of rating downgrades exceeding the number of upgrades, which constitutes a reversal from the positive trend seen during the rest of 2014.

Fixed Income Market Review Continued

Chart 4: US, UK and European investment grade credit spreads

Source: Merrill Lynch, as at 30 September 2014

Following the summer lull, the new issuance market gained some momentum in September, notably in continental Europe. German airline operator Lufthansa successfully issued a €500m bond with a yield of just 1.13%. European financial institutions continued to dominate the new issuance market, aiming to take advantage of investors' hunt for yield to respond to regulatory pressure and build their capital buffers. Broadly speaking though, demand faded, with investors asking companies for a larger premium for holding new debt over the secondary market. Another new trend was the popularity of longer-dated maturities as they offer higher returns than shorter-dated ones, at a time when companies have become increasingly willing to lock in cheap financing for longer periods. As such, the historically short-dated European credit market saw a surge in bonds with a maturity date of more than 10 years while the US saw an increase in lending to US companies and municipalities for up to 100 years.

High yield

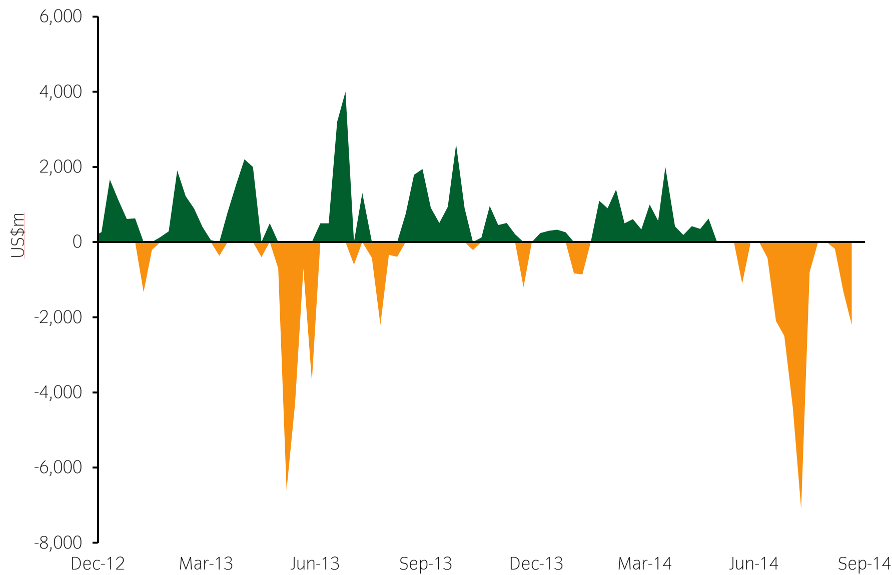
After a strong start to the quarter, the mood changed towards the end of July. During her testimony to the US Congress, Federal Reserve chair Yellen warned that valuations in some sectors, such as lower-rated corporate debt, appeared to be 'stretched'. Her comments prompted the start of a slew of outflows from high yield in the US which had a knock-on effect on the European market. Both US and European markets continued to be weak over August with liquidity poor and outflows from the asset class continuing. However, the market in the US regained some of the lost ground after yields hit the 6% level, at which point some larger investors stepped in to add risk to their portfolios.

Chart 5: High yield spreads

Source: Merrill Lynch and JP Morgan, as at 30 September 2014.

Fixed Income Market Review Continued

Chart 6: US retail fund flows



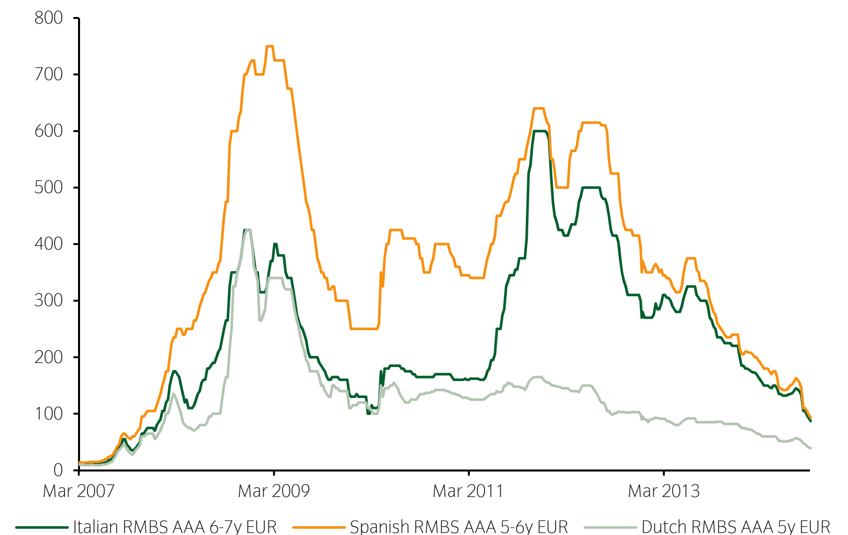
Source: Merrill Lynch and JP Morgan, as at 30 September 2014.

Yields and spreads in high yield remained stable in early September, however excess supply and rising treasuries yields started to unnerve the market, prompting renewed fund outflows. September began a bit more positively in Europe but it soon weakened in sympathy with the US high yield markets, with liquidity vanishing and new issues trading off several points.

Asset-backed securities

The start of the quarter was fairly uneventful for the asset-backed securities (ABS) market, but the escalation of geopolitical risk meant that risk aversion took hold, with reduced trading volumes and widening spreads, particularly in the higher-beta parts of the ABS market. A combination of improved flows towards the end of August and a quietening of the Russia/Ukraine situation saw the ABS market stage a small recovery, with many investors taking advantage of the weaker pricing to add to their positions.

Chart 7: European AAA-rated Asset Backed Securities (bps)



Source: Barclays and JP Morgan, as at 30 September 2014.

September saw a significant tightening in ABS, contrary to the weakness experienced in the broader risk markets. The catalyst for this move was the ECB, which announced it would be buying selected ABS with a wide ranging and sizeable purchase programme. The ECB in June had hinted that it would be looking at making secondary market purchases ABS, but its September announcement was much more aggressive than had been expected. Against this background, many parts of the ABS market performed strongly, with the largest moves seen in peripheral Eurozone ABS.

Fixed Income Market Review Continued

Currency

Volatility in the currency markets, which had broadly declined for over a year, fell to a multi-year low at the beginning of July. However, it subsequently rose through to the end of the quarter. Volatility remained low compared to historic levels but the quarter marked the return of some clear trends to the currency markets. Most notably, there was a sharp recovery in the US dollar (USD) relative to a range of currencies in September.

Chart 8: USD/JPY exchange rate

Source: Bloomberg, as at 30 September 2014

In July, geopolitical tensions served to keep pressure on US treasury yields despite the improvement in US economic data. The euro (EUR) depreciated relative to the USD. Along with the Russia/Ukraine conflict, the diverging monetary policies of the US and the eurozone became clearer and supported a stronger dollar. The USD also rose slightly against the Japanese yen (JPY) in response to evidence that the Japanese economy was losing some growth momentum.

In August, the Fed made it clear that if the labour market continued to improve at the same pace of recent months then the Fed would need to consider hiking rates earlier than expected to keep inflation under control. Against this backdrop the USD gained value against the EUR, JPY and sterling. In Europe, continuing signs of decelerating growth, combined with falling inflation expectations, led the European Central Bank (ECB) to signal that it was considering further monetary easing measures, which weighed on the EUR.

Chart 9: USD/EUR exchange rate

Source: Bloomberg, as at 30 September 2014

In September, there was significant USD strength relative to a variety of currencies. As the end of the Fed's quantitative easing (QE) programme drew near, the market began to focus on the fact that continued improvements in the labour market were likely to bring rate hikes forward, and US bond yields rose. This was in contrast to the eurozone, where weak growth and falling inflation expectations led the ECB to cut interest rates again, and to announce a new plan intended to ease monetary policy through the purchase of asset-backed securities and covered bonds. The stark contrast between Fed and ECB policy meant that the USD continued to strengthen versus the EUR.

Investment Outlook

DORSET LIABILITY MATCHING PORTFOLIO

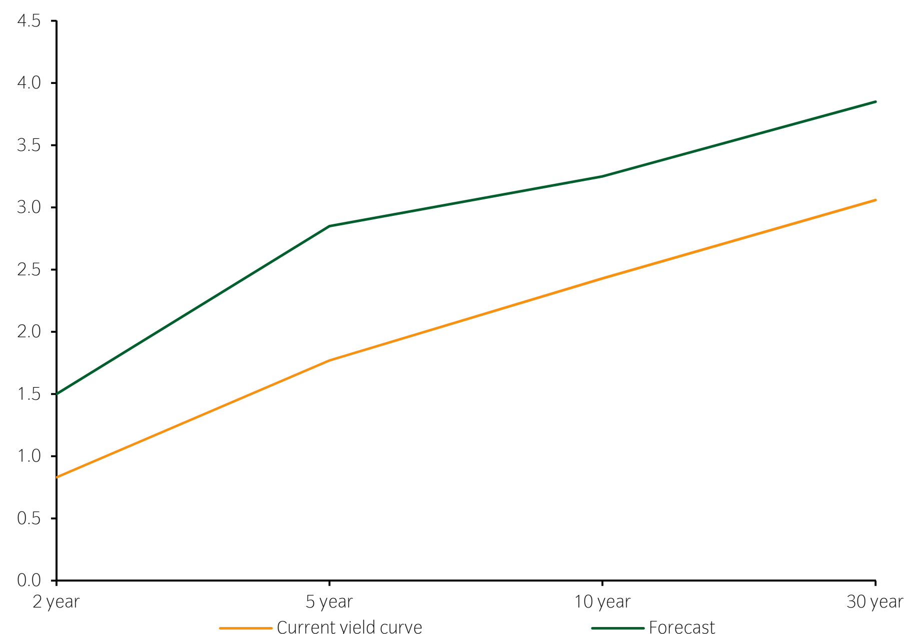
For the period 01 July 2014 to 30 September 2014

Fixed Income Outlook

UK

Our latest round of economic forecasting marks something of a milestone for the UK, as it is the first time in five years that we have included a rate change in our 12-month view. We are pencilling in two 25bps increases for the period up to mid-2015. To some extent this forecast is simply the weighted average of several possible outcomes. This could mean a start in rate rises as early as November this year, or further into 2015. Beyond this time horizon, the market is only pricing in at most 20bps per quarter, which feels a little low to us given the data. Much depends on the path of growth and forward-looking indicators over the next few quarters. As a base case we are forecasting a degree of yield rises over the next 12 months and prefer short duration positions as a result.

Chart 1: UK gilt yield curve (%)



Source: Bloomberg, as at 30 September 2014.

Eurozone

The latest package of stimulus measures deployed by the ECB looks set to reinforce a tightening bias in peripheral spreads. As such, we are positioned for the likely continued outperformance of Italy and Spain relative to Germany, although we remain tactical in our positioning given the extent of the spread tightening that has already occurred. We think short-dated peripheral bond spreads in particular have the most potential to narrow, as the liquidity made available by the ECB looks set to flow into short-dated, higher-yielding European government bonds.

While we expect interest rates to stay very low while the global economy slowly recovers, we believe we may be nearing the lows in core European yields for the cycle. We expect core yields to move higher over the next several months, in line with US and UK government bond yields, while also reflecting the improved growth outlook. With bund yields at historic lows, we believe that the likelihood of yields rising is higher than the probability of further falls.

Indeed, the yield on Germany's 10-year government bond did turn higher in September, tracking the rise of the equivalent government bond in the US, before falling again into quarter end.

We recently moved underweight duration in Germany at ten years, given that yields have fallen to their 2012 lows, but recognise that risks to this view remain. It is possible that the eurozone could remain mired in a low growth, low inflation environment should the expected, gradual economic recovery fail to materialise there. Meanwhile, geopolitical shocks could equally add further risks to Europe's already precarious economic situation.

Fixed Income Outlook Continued

In such a scenario, the ECB could consider moving to full-scale quantitative easing (QE), including the purchase of sovereign bonds. However, given the level of resistance to outright QE from Germany and the logistical challenges involved in coordinating purchases across the 18 countries that use the euro, the ECB may prefer to continue targeting private assets.

US

We believe that if the current pace of improvement continues, then the economic conditions that will prompt the first change in US rates in more than six years will be met in early summer 2015, but in our view the market is not currently discounting this. Thereafter, we expect a steady increase in rates to reach a peak of 3.5% at the end of 2017, below the peak of the last cycle.

We anticipate that, as the year progresses, the rate hiking cycle may be increasingly priced in by the market and the curve will flatten, resulting in the underperformance of short-dated securities. As a consequence, we are managing duration generally from the short side with a particular focus on shorter-dated debt.

The main risk to our view is an unexpected but material slowing of US economic growth. The most likely causes of this would either be further turmoil in Europe, a deterioration in developing economies or a slowdown caused by a premature tightening of financial conditions in the US.

Investment Grade

We believe that the current environment for corporate bonds continues to be supportive as corporate balance sheets are generally strong and the default rate is low and should stay that way given that funding costs are likely to remain manageable. In addition, investment grade credit is still seeing some inflows as investors continue to search for yield. However, we view the recent slowdown as a confirmation of our long-time belief that valuations in the lower quality areas of the corporate bond market have become stretched. With spreads and yields so compressed, we remain cautious about having much directional credit risk in portfolios and prefer to use our risk budget on stock selection and relative value ideas.

We currently favour US dollar and sterling-denominated investment grade credit over those issued in euro. In terms of sectors, we continue to prefer financials (especially banks) over non-financials on valuation and leverage trends. A rise in corporate leverage remains a risk to credit fundamentals and consequently we prefer companies which have already completed expansion plans.

EMD

Emerging market assets continue to be driven in part by external forces and are particularly sensitive to developments in the US given the negative impact of a strengthening US dollar and as the Fed remains on course to end its bond-buying programme in October. Should US treasury yields continue to rise in lockstep with the US dollar, the combination could prove to be an insurmountable headwind for emerging market fixed income. Therefore, we have maintained a US treasury short position, albeit reduced in size.

The political, economic and policy outlooks for a number of emerging market countries have become increasingly more divergent, which could create some significant buying opportunities over the coming months. The search for yield is also likely to continue as the ECB looks set to remain accommodative for the foreseeable future, further supporting the outlook for EMD. Some emerging market countries like Mexico, India and Indonesia have been making necessary structural adjustments and appear better placed to withstand a withdrawal of liquidity in the US.

In light of the volatility experienced during the third quarter, we prefer to adopt a cautious stance. We are also employing a tactical approach given some retracement is possible in the near term as greater clarity about Fed's exit strategy emerges but also because it is becoming increasingly more evident that global rates, particularly in Europe, remain anchored.

Fixed Income Outlook Continued

High yield

The current key issuance for the asset class is outflows. Any further outflows are likely to put more pressure on spreads and we anticipate continued volatility into year-end. However, against this background it remains the case that European interest rates are at record lows, and this will continue to drive the hunt for yield. It is likely that credit spreads will eventually start to narrow again despite the current volatility. The upside to this situation is that valuations in short-dated high yield have become attractive again, enabling us to invest in what we view to be good quality paper at around the 5% mark. However, careful stock selection in this market is vital to be successful in order to best withstand any selloff and to avoid defaults.

In terms of relative value, US spreads look much more attractive versus spreads in Europe, and given the size and liquidity advantages of the US, the opportunities are more plentiful there too. For 2014, we expect the European high yield market as a whole to return around 6%, assuming a continuation of the low growth environment with little or no increase in bund yields and very low default rates.

ABS

We have maintained exposure to peripheral eurozone market on the expectation that these assets will benefit further from the ECB's interest. Elsewhere, the UK residential mortgage-backed securities market remains one of our core positions on the back of a combination of improving economic data and the government support for the housing market. We have also been reducing exposure to UK non-conforming paper while increasing our allocation to collateralised loan obligations as we believe these may be the cheapest asset class within credit on a risk-adjusted basis. We have also been finding opportunities to add residential risk in Australia and commercial backed risk in the US.

Our outlook for the rest of 2014 and going into 2015 is for a continued normalisation of the asset class. Spreads remain well above their pre-crisis levels and the positive sentiment generated by the ECB's actions will no doubt continue to support the asset class.

Loans

We expect to see a continuation of high levels of new issuance into the last quarter with businesses taking advantage of the low cost of financing. Of course the quality of the companies issuing will vary widely and careful security selection is critical. Although default rates have risen since last year we are forecasting a stabilisation at these levels. The recent increase in sub-investment grade credit volatility has caused some investor outflows but a current levels we expect to see money flow into loans given the more attractive levels and more investor-advantageous deal structures.

Currency

Looking ahead, we expect the US dollar to remain strong. However, to strengthen much further from here, it will probably require interest rate support for the USD through rising rate expectations and higher bond yields in the US. Economic data in the US will be key as it is the primary driver for Fed action going forward.

Appendices

DORSET LIABILITY MATCHING PORTFOLIO

For the period 01 July 2014 to 30 September 2014

Summary Portfolio Valuation

As at 30 September 2014

	Book Cost GBP	% of Total Book Cost	Market Value GBP	% of Total Market Value
Fixed Income				
Sterling				
Investment Funds	197,957,061.56	100.00	255,811,376.56	100.00
Total Sterling	197,957,061.56	100.00	255,811,376.56	100.00
Total Fixed Income	197,957,061.56	100.00	255,811,376.56	100.00
Liquidity				
Total Liquidity	3,950.27	0.00	3,950.27	0.00
Total	**197,961,011.83**	**100.00**	**255,815,326.83**	**100.00**

Acquisitions and Disposals Summary

For the period 01 July 2014 to 30 September 2014

	Book Cost GBP	Accrued Interest GBP	Settlement Amount GBP	Realised Profit/Loss Market GBP	Realised Profit/Loss Currency GBP	Realised Profit/Loss Total GBP
Acquisitions						
Fixed Income						
Sterling						
Investment Funds	50,000,000.00	0.00	50,000,000.00			
Total Sterling	**50,000,000.00**	**0.00**	**50,000,000.00**			
Total Fixed Income	**50,000,000.00**	**0.00**	**50,000,000.00**			
Liquidity						
Sterling						
Cash Funds	99,940,000.00		99,940,000.00			
Total Sterling	**99,940,000.00**		**99,940,000.00**			
Total Liquidity	**99,940,000.00**		**99,940,000.00**			
Total Acquisitions	**149,940,000.00**	**0.00**	**149,940,000.00**			
Disposals						
Liquidity						
Sterling						
Cash Funds	99,940,000.00		99,940,000.00	0.00	0.00	0.00
Total Sterling	**99,940,000.00**		**99,940,000.00**	**0.00**	**0.00**	**0.00**
Total Liquidity	**99,940,000.00**		**99,940,000.00**	**0.00**	**0.00**	**0.00**
Total Disposals	**99,940,000.00**	**0.00**	**99,940,000.00**	**0.00**	**0.00**	**0.00**

Notes

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