DORSET COUNTY PENSION FUND

Quarterly Report 31 December 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 iBoxx Sterling Non-Gilt Over 5 Year Index.	100.0

Portfolio value

	Portfolio total (£m)
31 December 2014	**274.92**
30 September 2014	261.26
Change over quarter	13.66
Net cash inflow (outflow)	0.00

ROYAL LONDON

EXECUTIVE SUMMARY

Performance

- Your fund gave a return of 5.24% over the quarter, compared with a benchmark return of 5.48%. This brings 2014 performance to 16.37% versus the benchmark of 15.65%.

The economy and bond markets

- UK GDP growth was 0.7% for quarter three, and probably just below 3% for 2014. Consumer Price Index (CPI) inflation fell to 1% year-on-year in November, the lowest rate in ten years. The Bank of England kept the base rate at 0.5% and suggested a rise in interest rates was still some way off.
- Amid surprisingly buoyant US economic data, the US Federal Reserve (Fed) ended its quantitative easing programme but appeared likely to maintain interest rates for some time. Eurozone growth and business confidence weakened, and Greek elections renewed stability concerns. The European Central Bank (ECB) hinted at further monetary expansion, possibly full-blown quantitative easing, in 2015. In China, growth remained below pre financial crisis levels, while the Bank of Japan announced further stimulus measures as the economy fell back into recession.
- Conventional gilts returned 6.31% over the quarter on falling oil prices and global growth concerns. Medium dated gilts outperformed on a duration adjusted basis. Gilts generally outperformed other developed global markets. Index linked gilts returned 8.38% for the quarter; longer dated real yields fell to record lows. Breakeven inflation rates, particularly at shorter maturities, reflected lower inflation expectations.
- Sterling investment grade credit bonds returned 4.35%. Credit spreads increased from 1.13% to 1.26%. All non-financial sector spreads widened, with the performance of the general industrials sector, energy companies in particular, negatively impacted by falling oil prices. Global high yield bonds returned -1.15%.

Investment outlook

- Our central case is that the current global expansion will be sustained into 2015.
- We expect global government bond yields to trend higher as we move closer to rate hikes in the US and UK. We expect a very gradual rise in policy rates and not a dramatic sell-off in government bonds over the next twelve months. We believe that long term real interest rates of -0.75%, seen in December, do not reflect long term economic fundamentals.
- While we expect significant challenges in sterling fixed income markets in 2015, we believe that the pricing of credit bonds undervalues the asset class, relative to government bonds. We expect that sterling investment grade credit bonds will outperform gilts by approximately 1.5% p.a. over the next three years.

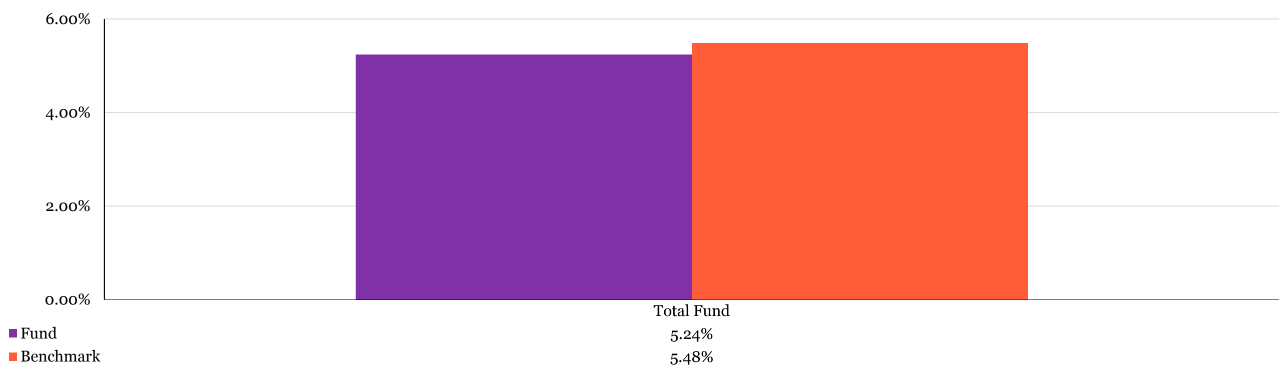
FUND PERFORMANCE

The table below shows the gross performance of your portfolio and the benchmark for the periods ending 31 December 2014:

Performance

	Fund (%)	Benchmark (%)	Relative (%)
Q4 2014	5.24	5.48	-0.24
Year to date	16.37	15.65	0.72
Rolling 12 months	16.37	15.65	0.72
Three years p.a.	11.24	8.85	2.39
Five years p.a.	13.57	12.12	1.45
Since inception 02.07.07 p.a.	9.91	10.04	-0.13

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 4 2014

Asset split

	Fund (%)	Benchmark[1] (%)
Conventional credit bonds[2]	99.8	98.8
Index linked credit bonds	0.0	0.0
Sterling conventional gilts	0.0	0.0
Sterling index linked gilts	0.0	0.0
Foreign conventional sovereign	0.2	1.2
Foreign index linked sovereign	0.0	0.0
Derivatives	0.0	0.0

Fund data

	Fund	Benchmark[1]
Duration	9.9 years	10.2 years
Gross redemption yield[3]	3.85%	3.32%
No. of stocks	244	716
Fund size	£275.0m	-

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 (%)
Q4 2014	**5.23**	**5.48**	**-0.25**
Year to date	16.44	15.65	0.79
Rolling 12 months	16.44	15.65	0.79
Since inception p.a. (02.07.2012)[2]	11.90	9.82	2.08

[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.

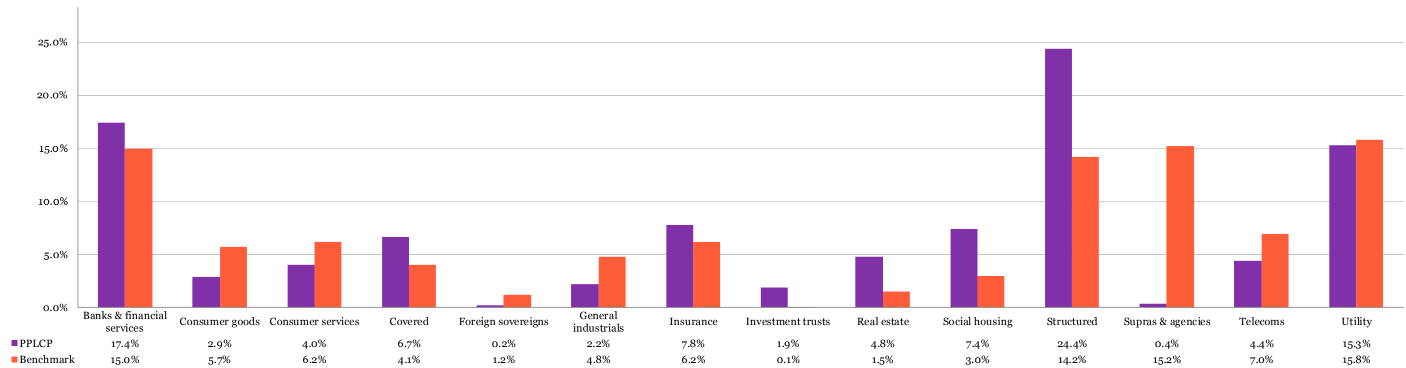
The fund returns in the above table are gross of standard management fees and include the impact of cash holdings over the period.

ROYAL LONDON

RLPPC UK OVER 5 YEAR CORPORATE BOND FUND

Quarter 4 2014

Sector breakdown



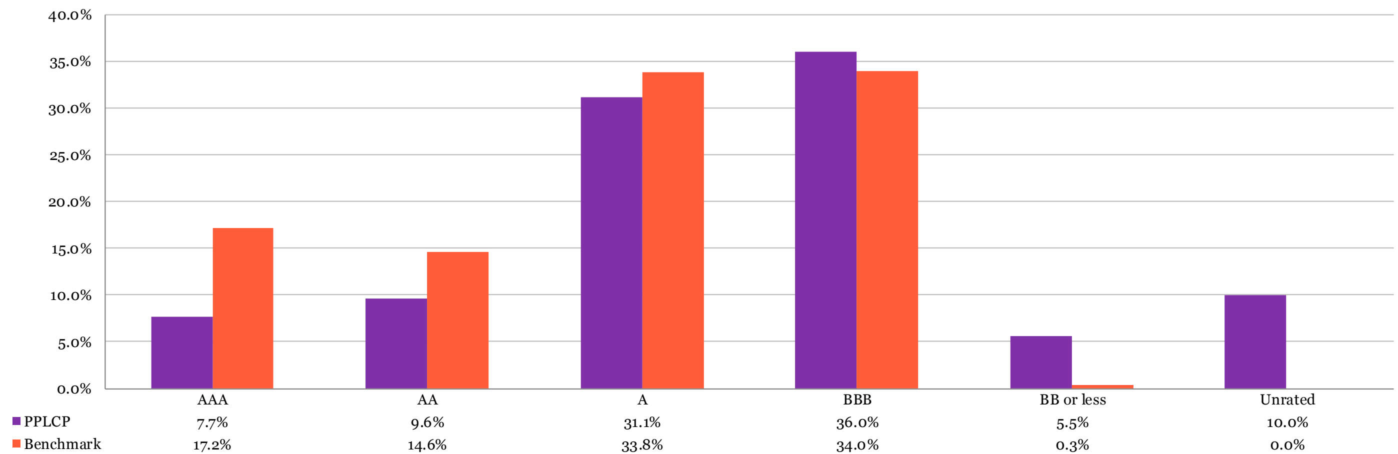
Source: *rlam. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio.*

What we thought	What we did	What happened	Effect on portfolio
We expected that medium and long dated corporate bonds would outperform equivalent supranational debt.	We maintained a significantly underweight position in supranational bonds; the fund's exposure to gilts was sold early in the quarter.	Supranational bonds outperformed the overall sterling credit market.	The underweight position in supranational debt had a negative impact on fund performance.
We continued to prefer a combination of covered bank bonds and subordinated bank debt to senior bonds.	There was no significant change to positions within the allocation to financial bonds.	Covered bonds outperformed senior bank debt. There was significant underperformance from subordinated bank debt, reflecting an increase in risk aversion.	The positioning within the financial sector was a not a material factor in relative performance.
We thought that high profile consumer orientated bonds were unattractively priced relative to corporate debt.	We maintained an underweight exposure to such bonds. However, given the underperformance over 2014, the underweight exposure was marginally reduced through new issue purchases.	On-going weakness in the food retailing sector, reflecting further intensification of the latest supermarket price war, resulted in consumer bonds underperforming the overall sterling credit market.	Overall, the low weighting in high profile consumer debt benefitted performance.
We continued to believe that secured bonds were undervalued relative to unsecured debt.	We increased the fund's significant overweight position in sectors that benefit from enhanced security e.g. asset backed securities (ABS), social housing and investment trusts, both through new issue purchases and secondary market trades.	Secured and ABS bonds underperformed the overall sterling credit market, reflecting profit taking by investors after the strong absolute and relative performance over the year. The underperformance was also attributable, in part, to the high weighting of Tesco CMBS within the index; the bonds underperformed markedly over the quarter.	The overweight exposure to ABS was marginally detrimental. The position in secured Tesco debt was a negative factor in fund performance.

RLPPC OVER 5 YEAR CORPORATE BOND FUND

Quarter 4 2014

Rating breakdown



	AAA	AA	A	BBB	BB or less	Unrated
PPLCP	7.7%	9.6%	31.1%	36.0%	5.5%	10.0%
Benchmark	17.2%	14.6%	33.8%	34.0%	0.3%	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.*

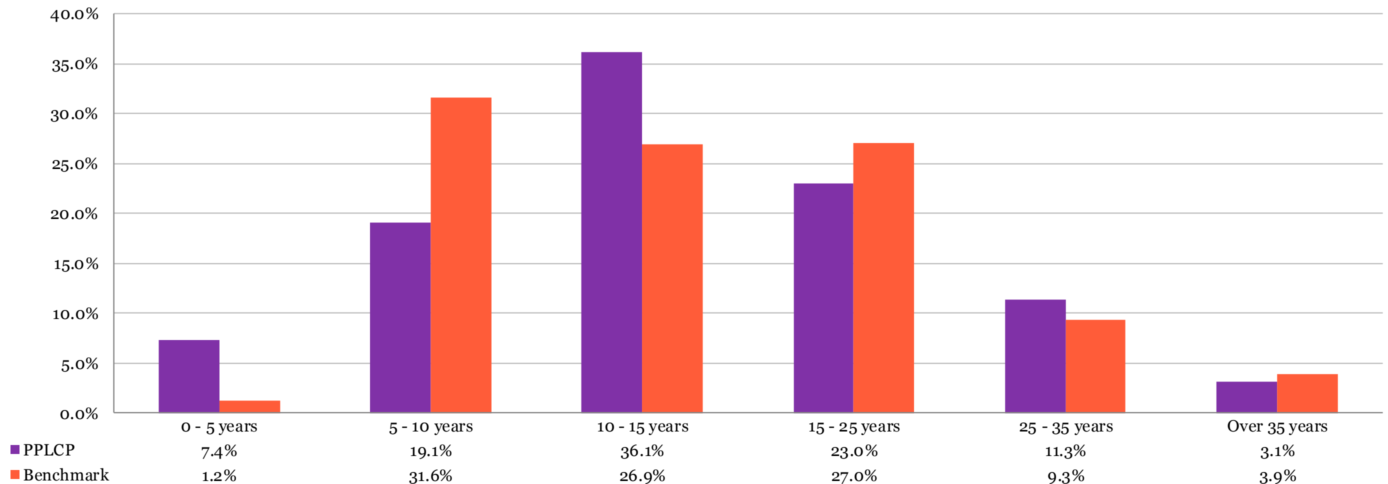
What we thought	What we did	What happened	Effect on portfolio
We believed that lower rated bonds offered better value than AAA / AA rated securities.	The overweight exposure to lower rated bonds was increased through the sale of gilts; proceeds were invested in A and BBB rated new issues.	BBB debt underperformed, reflecting increased risk aversion over the quarter. However, for the year as a whole, the BBB sector was the best performer, duration adjusted.	The credit rating profile of the portfolio was detrimental to overall fund performance.
We believed that certain unrated bonds were attractively priced.	We maintained exposure to unrated bonds; most of these bonds are secured against assets of the issuer.	Unrated bonds performed broadly in line with credit indices.	No impact on relative performance.

ROYAL LONDON

RLPPC UK OVER 5 YEAR CORPORATE BOND FUND

Quarter 4 2014

Maturity profile



	0 - 5 years	5 - 10 years	10 - 15 years	15 - 25 years	25 - 35 years	Over 35 years
PPLCP	7.4%	19.1%	36.1%	23.0%	11.3%	3.1%
Benchmark	1.2%	31.6%	26.9%	27.0%	9.3%	3.9%

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

What we thought	What we did	What happened	Effect on portfolio
We expected UK government yields would rise towards the year end.	Fund duration was reduced marginally over the quarter, with an overall bias to be short duration versus the benchmark index.	Bond yields declined across the yield curve, with yield decreases greatest at medium and long maturities. The main drivers of the lower bond yields were falls in commodity prices pushing global inflation rates lower, weak eurozone growth data and the prospect of full-blown quantitative easing by the European Central Bank.	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.	While, in absolute terms, longer dated bonds were the best performers over the quarter, this was driven wholly by the fall in underlying gilt yields. However, in keeping with the trend throughout 2014, long dated bonds were the stark underperformers when adjusted for duration. Credit spreads widened 0.18% and 0.24% for the quarter and year, respectively, versus 0.13% and 0.08% for the broader sterling credit market.	Yield curve positioning was not a material factor in relative performance.

RLPPC UK OVER 5 YEAR CORPORATE BOND FUND

Quarter 4 2014

Ten largest holdings

	Rating	Weighting (%)
Lloyds Bank Plc 6% 2029	AAA	1.4
Annington Finance 0% 2022	AAA	1.2
Great Rolling Stock Co Plc 6.875% 2035	BBB	1.0
Finance for Residential Social Housing 8.369% 2058	A-	1.0
Equity Release Funding 5.88% 2032	A	1.0
Co-Operative Bank 4.75% 2021	BBB-	1.0
Abbey National Treasury 5.75% 2026	AAA	1.0
Equity Release 5.7% 2031	A	1.0
Bank of America 7% 2028	A-	0.9
ENEL Finance 5.75% 2040	BBB	0.9
Total		**10.4**

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

RLPPC UK OVER 5 YEAR CORPORATE BOND FUND

Quarter 4 2014

Fund activity

- New issuance activity in sterling investment grade credit bonds reduced significantly in the latter part of the quarter. Nevertheless, the fund participated in several new issues over the period.
- The fund participated in a new issue by **Health Care REIT Inc** (HCN), one of the largest healthcare REITs in the US. HCN leases senior housing to operators under long term leases linked to CPI and in some cases also participates in the profitability of the housing itself. The bonds are unsecured but benefit from standard REIT covenants (e.g. interest cover, Debt/Assets and limits on encumbrance). We believe that the offered yield premium above the benchmark gilt of 1.90% represented good value for a BB rated bond.
- Despite the significant underperformance of the retail sector during 2014, we remain cautious, especially concerning food retailing companies. Nevertheless, we purchased a debut transaction from **Walgreens Boots Alliance**, a multinational drug retailing chain, offering both diversification away from the food retail sector and also the UK. The issuance of these 11 year bonds was prompted by the issuer purchasing the remaining stake in the UK operator Boots, and they were offered with a yield premium of 1.40% over UK government bond yields. Also during the quarter, **John Lewis** came to the market with an unrated 20 year bond with a yield premium of 1.90%. The bonds were well received, reflecting the company's robust performance against the headwinds faced by the sector. Both bonds are unsecured and are new names to the current portfolio.
- Within financial sectors, we purchased a new lower tier 2 instrument issued by **RSA**, offering a 5.125% fixed coupon for the first 11 years. We believe that the insurance sector offers good relative value and that the 2.80% yield premium was attractive given the new strategy of the insurer, which is focussed on streamlining the business, with an ongoing emphasis on de-leveraging as well improving its capital position. We also added to our exposure to **Yorkshire Building Society**, the second largest UK building society, through the purchase of a new lower tier 2 bond, its first subordinated transaction since the financial crisis, callable in 2019. The BBB+ rated bonds were issue at yield of 2.90% above the benchmark gilt, which is one of the widest in the sector at this maturity.
- Social housing issuance kept pace with the robust levels seen throughout 2014. We added to the overall exposure within the fund through the purchase of a new long dated bond from **Yorkshire Housing**, offering a yield premium of 1.35% over UK government bond yields.
- In the secondary market we established new positions in utility company **SP Manweb** and structured bonds from **Meadowhall** and **Dignity Finance**, along with increasing existing exposures to social housing bonds from **Peabody Capital** and telecoms giant **America Movil**. Within financial sectors, we increased expose to **IPIC** and switched between issues from **Barclays**.
- There were few sales in the quarter; we sold the fund's position in gilts and reduced exposure to **Motability**.

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.

ROYAL LONDON

ECONOMIC REVIEW

Key points

- Global growth in quarter four, and in 2014 as a whole, remained well below pre-crisis levels.
- Data from the eurozone indicated that economic recovery had stalled, while strong US growth continued into quarter four.
- The US Federal Reserve (Fed) ended its quantitative easing programme and signalled that interest rates would rise in 2015.

Growth

- Given investor expectations at the beginning of 2014, global economic performance has disappointed, principally due to the stalling of an incipient economic recovery in the eurozone, but also due to a loss of momentum in Asia.
- US economic data has continued to surprise on the upside; GDP grew by an average of 4.8% (annualised) in quarter two/three, while recent business surveys and labour market data suggest growth continued in quarter four, albeit at a slower rate. Despite downside risks, it appears that fears of growth being stuck at 2% were premature. Labour resources remain underutilised, allowing room for the US economy to grow above trend for some time.
- Eurozone GDP grew by just 0.2% in quarter three, with the Purchasing Managers' Indices (PMIs) pointing to a similar pace in quarter four. It is likely that the weakening in business confidence partly reflected the heightened tensions between Russia and Ukraine. Business surveys have shown some signs of stabilisation, although an impending election in Greece has raised concerns about stability of the new euro arrangements.
- Estimates put UK GDP growth at 0.7% for quarter three, while the most recent business surveys (including PMIs) suggest that positive momentum continued into quarter four; average annual GDP growth for 2014 now looks to have been just under 3%. One of the forces squeezing the UK economy in 2011/12 was the high cost of energy. This is now reversing, and a sustained reduction in the price of oil should act as a support for growth, via its effect on the costs of production and real incomes. Credit conditions for households have improved markedly since the middle of 2012, with a sharp decline in mortgage and personal loan rates, while consumer confidence remains well above its pre-crisis average.
- In China, growth remained below pre financial crisis levels, with manufacturing and service PMIs declining in the latter part of 2014. Japan's economy fell back into recession in quarter three, with GDP falling by 0.4%. The Bank of Japan announced further stimulus measures in November, while the Prime Minister postponed a second increase in sales taxes that had been due to take place in 2015.

Inflation

- Inflation, as measured by the UK Consumer Price Index (CPI), fell to just 1.0% year-on-year in November, reflecting lower food price inflation, falling fuel prices, and the lagged effect of sterling appreciation.
- Survey-based measures of inflation expectations fell, while wage pressures showed some modest signs of improvement.
- These trends were repeated in other developed economies; US CPI fell to 1.3% and eurozone CPI to 0.3% in November.

Interest rates

- Official interest rates, for most developed economies, remained at minimal levels throughout 2014. However, in quarter four, the European Central Bank (ECB) indicated that it wanted to expand its balance sheet by €1 trillion, reversing the contraction seen in recent years. This is likely to lead to sovereign quantitative easing in 2015. Conversely, the Fed ended its quantitative easing programme, although the Chair of the Fed, Janet Yellen, reiterated the commitment to keeping interest rates at their current level for some time.
- In the UK, the Monetary Policy Committee (MPC) kept the bank base rate at 0.5%, with the November Inflation Report suggesting that a rise in interest rates was still some way off. Two members continued to vote for an immediate increase in rates. 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 broadly unchanged over the quarter, as weakness versus the US dollar was offset by strength against the euro. Over the year, sterling appreciated on a trade weighted basis, and ended the year 12% above the recent low of quarter one 2013.
- The main currency themes of the quarter, and the year overall, were Japanese yen and euro weakness and US dollar strength, reflecting divergent growth prospects.

ROYAL LONDON

BOND MARKET REVIEW

Investment grade: financial & corporate bonds

Key points

- Sterling investment grade credit bonds returned 4.35% in quarter four, the highest quarterly performance of the asset class since quarter three 2012. This reflected the significant fall in gilt yields in the period.
- Credit spreads, the average yield differential between sterling investment grade credit bonds and gilts, increased from 1.13% to 1.26%; all non-financial sectors registered a move higher in credit spreads.

Credit spreads

- In quarter four, sterling investment grade credit bonds returned 4.35%, underperforming UK government bonds by 1.08%, duration adjusted, and bringing 2014 returns for the asset class to 12.20%.
- Credit spreads widened, with the average yield differential between sterling investment grade credit bonds and gilts increasing by 0.13% to end the quarter at 1.26%, marginally higher than the 1.18% prevailing at the start of the year.
- Most sectors saw a widening of credit spreads, with the exception being banking where average spreads were broadly unchanged. Credit spreads remain wider than levels consistent with the long run corporate default rate.

Financial sectors

- There was significant variation in returns between different tiering bands. Tier 2 bonds generally performed poorly, whilst senior and covered bonds recorded better relative performance. For 2014, covered bonds were by far the strongest financial sector.
- The insurance sector performed broadly in line with the wider sterling credit market, with average credit spreads widening by 0.13%. The sector returned 4.11% over the quarter and 11.75% for 2014 as a whole.

Non-financial sectors

- All sectors underperformed gilts over the quarter, for the second consecutive quarter.
- The weakest area was general industrials, where falling commodity prices had a detrimental impact; the energy sub-sector recorded credit spread widening of 0.44%, reflecting the dramatic decline in oil prices.
- Retail orientated consumer bonds also underperformed, reflecting fierce competition in food retail markets.

Issuance, ratings and maturities

- Issuance of sterling investment grade debt in quarter four was £8.7bn, an increase over quarter three. However, activity tailed off significantly in the latter part of the period, with little issuance recorded in December. Issuance between financials and non-financials was again evenly split, a continuation of a theme seen throughout 2014.
- Overall, £40.3bn of new sterling investment grade debt was issued in 2014, a marginal increase on 2013.
- Relative returns were correlated with credit ratings i.e. the higher the credit rating band the lower the credit spread widening (i.e. more highly rated credit bonds tended to outperform). For the year as a whole, however, BBB rated bonds gave the best duration adjusted return.
- By maturity, the lowest absolute returns were recorded by the shortest dated bonds, reflecting their relative lack of interest rate sensitivity, with only marginal credit spread widening. The weakest area, on a duration adjusted basis, was at the long end (over 15 years to maturity) where the return of 6.47% lagged comparative gilts by 2.52%.

Outlook

- There will be significant challenges to sterling fixed income markets in 2015 (e.g. the UK general election, monetary policy of the ECB and potential rate rises in several developed economies). Whilst it is likely that the volatility seen in the latter part of 2014 will continue into 2015, we believe that the pricing of credit bonds undervalues the asset class, relative to government bonds. We expect that investment grade credit bonds will outperform UK government securities by approximately 1.5% p.a. over the next three years.

ROYAL LONDON

BOND MARKET REVIEW

Conventional government bonds

Key points

- Conventional UK government bonds returned 6.31% in the quarter and 13.86% for the year.
- The Bank of England (BoE) Monetary Policy Committee (MPC) left its policy rate and quantitative easing unchanged at 0.5% and £375bn, respectively.
- The UK Consumer Price Index (CPI) inflation rate fell to 1% in November. The MPC minutes highlighted a spilt vote of 7-2, with two members voting for a 0.25% hike. The majority felt that the European situation and low spot inflation justified no change.
- On a duration adjusted basis medium dated gilts outperformed short and long dated gilts as the market rallied on falling oil prices and concern about growth prospects. Gilts outperformed both US and Europe as a hunt for extra yield continued.

Variation of return across the UK market

- Overall, the conventional UK government bond market returned 6.31% over the quarter, with short dated gilts returning 1.65%, medium dated gilts 5.31%, and long dated gilts 11.19%. Gilts generally outperformed other developed global markets.
- Government bond yield curves in the UK flattened between two and ten year maturities but steepened between ten and thirty years, as the bond market worried about global deflationary pressures. The yield curve steepened between thirty and fifty years as the market digested ultra long dated supply.
- The 2014 return from long dated UK government bonds, at 26.1%, represented the second highest return in the last ten years, surpassed only in 2011.

Overseas fixed interest markets

- Yields in core overseas markets fell over the quarter; peripheral eurozone markets (e.g. Italy and Spain) initially outperformed but reversed some of these gains later in the period.
- German government bonds yields fell to all-time lows, with two year maturity bonds trading at negative yields and five year bunds at close to zero. Bund yields are now at levels comparable with Japanese government bonds. The European Central Bank (ECB) maintained the policy rate at 0.05% and the deposit rate at -0.20%. Despite indication of full scale quantitative easing in 2015 the ECB has not been able to stem the market's fear of eurozone deflation.
- US ten year government bond yields declined to 2.17% despite relative strong economic growth being achieved.

Outlook

- We expect global government bond yields to trend higher from current levels, as US economic data improves and we move closer to rate hikes from both the Fed 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 twelve months.
- Our central case is for UK government bond yields to rise over 2015, although we expect some volatility around this trend. The high UK budget deficit means that gilt supply will remain heavy in 2015 and this should exert an upwards force on yields as the latest flight to safety abates.
- We expect government bond yields across maturities to rise over 2015 and for the yield curve to flatten.

ROYAL LONDON

BOND MARKET REVIEW

Index linked bonds

Key points

- Index linked gilts returned 8.38% in quarter four, as longer dated real yields fell to record lows.
- Real yields fell across maturities, globally, on fears of widespread deflation. UK government index linked bonds outperformed overseas markets, as demand from pension funds for longer dated bonds continued.
- UK Consumer Price Index (CPI) inflation fell to 1.0% in November, the lowest rate in ten years; oil prices fell by over 40%.
- Breakeven inflation rates, particularly for shorter dated bonds, fell as inflation expectations declined.

Real yield and breakeven (implied) inflation curve moves

- Real yields fell through most of the quarter, with long dated real yields reaching a record low of -0.75% in mid-December, before rising marginally by the year end. The current negative yields can be contrasted with real yields of 2% when index linked bonds were first issued in the early 1980s, and real yields of 4% that prevailed in the early 1990s.
- Breakeven inflation rates declined over the quarter as CPI inflation fell to its lowest level in ten years. The fall in implied inflation was greatest in the five year sector where breakeven inflation rates declined by 0.25%.

Variation of return across the UK market

- The real yield differential between ten and thirty year bonds rose by around 0.10%. In yield terms, the ten year sector was the best performing sector with real yields falling by 0.60% over the quarter.
- The FTSE Index Linked Gilts All Stocks Index gave a return of 8.38% over the quarter, giving a twelve month return of 18.96%. Index linked gilts posted positive returns across all maturities; the best performing area was ultra long dated bonds with returns in excess of 20%.

Overseas and credit index linked market

- The UK market outperformed all overseas markets over the quarter, reflecting ongoing demand by UK pension funds for inflation protected bonds.
- 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 -0.75%, as seen in December, are too low and do not reflect long term economic fundamentals.
- Pension fund demand for longer dated real yield securities remains strong. However, with supply of long dated index linked gilts in the first quarter of 2015 being high, we expect that UK government real yields will rise; against this background we expect that index linked gilts will underperform overseas markets.
- We believe that long breakeven inflation rates of 3.2% are above fair value and are expected to fall further. Shorter breakeven rates are more attractive but are likely to fall further as inflation falls in the first half of 2015.
- We believe that 10 and 30 year UK government real yields will rise towards 0.2% during 2015, significantly higher than current levels.

ROYAL LONDON

BOND MARKET REVIEW

Overseas government bonds

Key points

- Global bond yields declined significantly over quarter four 2014, reflecting fears of low growth and deflation. Ten year US government bond yields ended the year below 2.2%, whilst equivalent German yields fell below 0.6%. The hint of sovereign quantitative easing led to further tightening of peripheral yield spreads.
- Growth data was reasonable, with the US economy continuing to surprise on the upside; US GDP grew by an annualised rate of 4.8% in the six months to the end of September. Eurozone growth, conversely, was weak although not significantly different from expectations.
- Easier monetary policy in both Europe and Japan led to the trade weighted dollar index rising by 4.9% over the quarter.

Yield curve moves over the quarter

- Ten year government bond yields in the UK fell by 0.67% and in Germany fell by 0.41% to reach a record low. The US and Japan lagged, with equivalent yields falling by less.
- At the end of the quarter, ten year conventional government bond yields in the US, Germany, Japan and the UK were 2.17%, 0.54%, 0.33% and 1.76%, respectively.
- Real yields reflected the moves of conventional bond yields, although the move down was less pronounced. At the end of the quarter, ten year real yields in the US, Germany and the UK were 0.47%, -0.43% and –0.92%.
- Weak energy prices led to fears of global deflation and a sharp fall in implied inflation.US five year breakeven rates fell by 0.44% to 1.21%, whilst German five year breakeven rates fell to 0.66%.

Currency markets

- The US dollar continued to be the strongest currency as both the European Central Bank and Bank of Japan eased monetary policy further. Conversely, the US Federal Reserve took a more hawkish tone.
- Over the quarter, sterling was marginally weaker on a trade weighted basis.

Outlook

- We expect that global economic growth will be sustained over the near term; the risk of significant double dip recession has reduced.
- We expect US growth to remain reasonably strong and expect a move upwards in the Fed Funds rate in 2015.
- Events in the eurozone 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. However, the situation remains unpredictable; the fall in inflation is likely to bring forward the announcement of sovereign quantitative easing. We do not believe that yields on peripheral eurozone sovereign debt are attractive.
- Given the low level of real yields, we expect a rise from current levels, though this will be limited by global growth prospects. 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 do not anticipate a prolonged period of deflation and breakeven inflation rates at current levels offer longer term value.
- We expect that the UK will raise official rates in the latter part of 2015. However, further weakness in the Eurozone could result in postponement until 2016. We believe that developed government bond markets are expensive and that yields will rise in 2015.

ROYAL LONDON

BOND MARKET REVIEW

Global high yield bonds

Key points

- Global high yield bonds (BofA Merrill Lynch BB-B Global Non-Financial High Yield Constrained, 100% hedged to sterling) returned -1.15%; monthly returns were volatile over this period (October 1.04%, November -0.62%, December -1.56%). For 2014 as a whole, global high yield bonds returned 3.16%.
- Healthcare (2.73%) and media (2.01%) sectors outperformed; energy (-10.38%) and transportation (-2.95%) lagged.
- Global new issuance in the quarter was over $66 billion, down 18% on the same period last year and due primarily to a low level of issuance during October and December, owing to the weaker market. Issuance over 2014 was 1% down on 2013, with issuance in the first half of 2014, particularly in Europe, failing to make up for the weaker second half.
- The index yield ended the quarter 0.33% higher at 5.93%, with the average high yield credit spread widening by 0.44% to 4.67% above government bond yields. This spread is well above the all-time low of 2.06%, set in June 2007.

Regions

- The US and Canada region returned -1.12% for the quarter (2.38% for 2014). Credit spreads widened by 0.13%, while underlying government yields fell by 0.09%. November and December exhibited the weakest performances.
- Europe outperformed, returning 0.96% (6.08% in 2014). 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.
- Emerging Markets was the weakest performing region, returning -6.17% in the quarter (-1.30% in 2014), and continuing the trend observed in the third quarter, with spread widening accounting for virtually the entire move higher in yields.

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

Monthly performance

- October saw increased volatility in risk markets, with Ebola concerns compounded by the shaky cease-fire in Eastern Ukraine and oil price weakness. Early in the month, we saw the best day for the S&P 500 index thus far in 2014, followed by the biggest negative swing since 2011 the day after, with the drop led by the energy sector. Central banks also headlined, with the US Federal Reserve (Fed) officially announcing the end of its quantitative easing policy, while conversely, the ECB and Bank of Japan loosened monetary policy. Global high yield bonds returned 1.04% in October.
- October's initial oil price weakness continued into November, following the decision from Saudi Arabia to cut the price of the oil sold to the US and OPEC's refusal to reduce production levels. As the month progressed, the European Commission cut expectations of eurozone GDP and inflation growth, heightening concerns about economic recovery, and the ECB mentioned the need for more accommodative measures; Mario Draghi suggested that future easing actions could include the purchase of government bonds. Despite the concerns, the S&P 500 continued to show strength and closed the month at record levels. Oil prices, nonetheless, drove November global high yield performance down to -0.62%.
- Market volatility continued in December on weak oil prices and lower ECB expectations of eurozone growth and inflation, leading to renewed concerns about economic recovery. Focus then turned to Greece where a crucial presidential vote was brought forward by two months, triggering the worst price action on the Greek stock exchange since December 1987. The failure of Antonis Samaras' nominated presidential candidate to gain enough support led to parliament being dissolved with elections set for January. At the same time, the Russian rouble continued to suffer, pushing the Russian central bank to raise benchmark interest rates dramatically. Global high yield bonds returned -1.56% in December.

Ratings & maturities

- BB rated bonds outperformed B rated bonds over the quarter, returning 0.09% and -2.57%, respectively. Outside of the benchmark index, the Global High Yield CCC & Lower index returned -5.04%, illustrating how positioning based upon higher credit rating had a significant impact on overall performance.
- Returns for the quarter were worse at shorter maturities. Returns were -1.13% for 0 to 3 years, -1.60% for 3 to 5 years, -1.05% for 5 to 7 years, -0.91% for 7 to 10 years and -0.87% 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 market volatility as supportive Fed monetary policy is withdrawn. 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 in global high yield, a robust level of new issuance is expected for 2015.

ROYAL LONDON

INVESTMENT OUTLOOK

Key points

- Our central case is that the current global expansion will be sustained into 2015, with loose monetary policy, lower bond yields and a lower oil price acting as key supports.
- We expect UK Consumer Price Index (CPI) inflation to remain below the 2% target for many months, as the effects of the 2014 sterling appreciation and falls in commodity prices feed through.
- Government bond markets appear unduly pessimistic about the prospects for global growth; we expect global bond yields to move higher from current levels.

Global economic growth prospects

- Our central case is that the current global expansion will be sustained into 2015, with loose monetary policy, lower bond yields and a lower oil price acting as key supports. This assumes reasonably strong growth in the US, no material change in eurozone growth, and growth of c.7% in China, where low inflation will enable further policy easing. Some emerging economies will benefit from the recent fall in the oil price (e.g. India), while others lose out (e.g. Russia).
- We expect average annual US GDP growth of at least 3% in 2015. Lower mortgage rates should support housing activity, whilst consumption growth will be supported by gains in household wealth, higher employment and lower energy prices.
- Our base case for the eurozone in 2015 is slow growth rather than recession. We have kept the base case growth forecast unchanged, at 1.0%. This assumes growth is supported by an easing in fiscal policy, lower oil prices, a weaker currency and stronger US growth.
- The base case for the UK assumes good growth in 2015, with household spending supported by a return to real income growth, rising employment and lower inflation. It is likely that the General Election in May 2015 will create some uncertainty, which may impact consumer and business confidence. However, we believe that underlying global economic growth will support activity in the UK.
- 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 remain the key risk to the immediate outlook.

Inflation and growth – how will they impact interest rates?

- We expect UK CPI inflation to remain below the Bank of England's 2% target for many months, as the effects of the recent sterling appreciation and falls in commodity prices feed through with lags. Nevertheless, we believe the prospect of deflation is overstated; the currency impact should fade somewhat in 2015, while there may be strong upward base effects from energy prices towards the end of the year. Our base case also assumes a gradual firming in wage growth, as the labour market tightens, which should keep CPI close to 2% over the medium term.
- 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

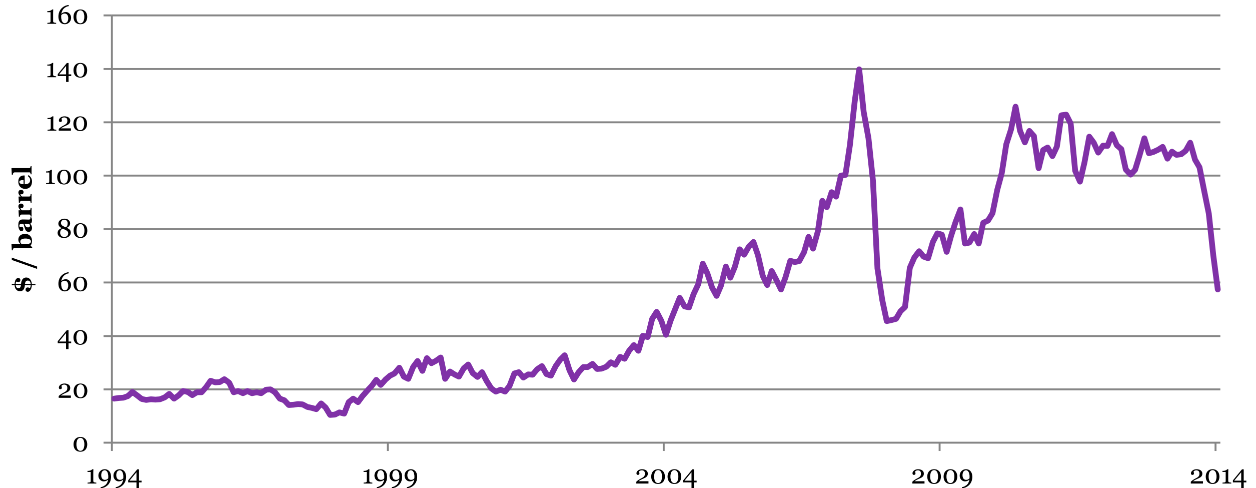
- Falling bond yields during 2014 reflected a perception that policy rates would remain lower than previously expected. Government bonds markets appear very bearish about the prospects for global growth. We expect yields to move higher from current levels, as much of this concern looks overdone. However our base case only assumes a very gradual rise in policy rates, so we do not expect a dramatic rise in yields over the next twelve months.
- Investment grade and high yield credit offer better relative value than government bonds. We believe that 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 approximately 1.5% p.a. over the next three years.

ROYAL LONDON

SPECIAL TOPIC

The impact of oil price movements

Oil prices have fallen to their lowest level in four years, driven by increased supply and weaker actual and anticipated global demand. A lower oil price will reduce headline inflation, particularly in the US, where the tax wedge between the wholesale and retail cost of energy is low. Given the potential volatility in headline inflation, the US Federal Reserve tends to focus more on core CPI (excluding energy), with the view that, when the two rates diverge, it is more likely that headline inflation settles at the core level than vice versa.



Source: Bloomberg

Most global econometric models suggest that a decrease in the price of oil will add to global GDP growth, albeit with a lag (c.1 year). A fall in the oil price transfers global GDP from oil producers to oil consumers, which should boost growth, assuming the propensity to spend additional income among oil-consuming countries is larger than it is in oil-producing economies. The major beneficiaries are likely to be those economies with high oil import bills, with the lower cost of energy acting like a tax cut for energy dependent firms and households. Despite the rise of shale oil and gas production in recent years, the US remains a net importer of petroleum. The lower oil price will squeeze US oil production in the medium term, particularly in those states which are most oil dependent. However, the effect on the overall economy should be offset by the potential boost to household demand and non-energy US companies.

So while the short-term effect of a fall in energy costs is disinflationary, ultimately it can be reflationary, and vice versa. Global recessions have often coincided with a sharp increase in the oil price, as this acts as a constraint on household and corporate demand. The International Monetary Fund has already indicated that they are likely to upgrade their forecast of global growth in 2015.

The main downsides from the lower oil price include the risk that inflation expectations become entrenched at very low levels. There is also the risk of financial contagion from some emerging markets, and that defaults in High Yield bonds will have a knock-on effect on general economic sentiment.

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.

ROYAL LONDON

RLAM TEAM

Your fund managers

Jonathan Platt
Head of Fixed Interest

Paola Binns
Senior Credit Fund Manager

Your dedicated contact

James Stoddart
Head of Client Account Management

T: 020 7506 6619
F: 020 7506 6784
E: james.stoddart@rlam.co.uk

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

Lucy Bramwell	T: 020 7506 6537	E: lucy.bramwell@rlam.co.uk
Fraser Chisholm	T: 020 7506 6591	E: fraser.chisholm@rlam.co.uk
Victoria McArdle	T: 020 7506 6563	E: victoria.mcardle@rlam.co.uk
Rob Nicholson	T: 020 7506 6736	E: robert.nicholson@rlam.co.uk
Daniel Norsa Scott	T: 020 7506 6602	E: daniel.norsascott@rlam.co.uk

Corporate team changes

In November we announced the appointment of Piers Hillier as Chief Investment Officer. Piers, who has more than 17 years' experience across asset management, succeeds Robert Talbut who left the organisation at the end of December after ten years with Royal London.

Distribution team changes

Within Client Account Management we said goodbye to Georgina Montalvo after 10 years at RLAM. We welcomed Rob Nicholson to the team as a Client Relationship Director and Victoria McArdle as a Client Relationship Manager.

ROYAL LONDON

GLOSSARY

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

Amortisation – Incremental repayment of a bond over its lifetime.

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

> **Stock selection** – Performance attributed to stock selection.
>
> **Yield curve** – Performance attributed to positioning on the yield curve.
>
> **Duration** – Performance attributed to relative duration of the portfolio versus that of the benchmark.
>
> **Asset allocation** – Performance attributed to asset allocation between fixed interest gilts and credit bonds.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

European Stability Mechanism (ESM) – A permanent rescue fund program designed to replace the temporary EFSF which commenced operations in October 2012.

FRN – Floating Rate Notes – a bond with a variable coupon. Typically, coupons of sterling FRNs are referenced against 3 month LIBOR and are reset quarterly.

Funding for Lending Scheme (FLS) – Launched in July 2012, the scheme is designed to lower bank funding rates by allowing banks and building societies to borrow directly from the Bank of England for up to 4 years. Those that increase lending to UK households and businesses will be able to borrow more in the FLS, and do so at lower cost than those that scale back lending.

Futures – A contract between two parties where one agrees to buy and the other to sell an underlying instrument at a future date at a price agreed at the start of the contract.

FX – Foreign exchange.

Gearing – The level of debt to equity.

Interest cover – The degree to which interest expense is covered by the profit of the issuer.

Interbank rate – Lending rate between banks in the wholesale money market; LIBOR stands for London InterBank Offered Rate.

Internal rating – RLAM's assessment of the creditworthiness of a bond; crucially this takes account not only of the probability of default of a company but also the likely recovery rate on default.

Investment restrictions – Restrictions imposed on the portfolio managers by clients as outlined in the investment management agreement (IMA).

Liability management exercise (LME) – Under certain circumstances, companies can offer to buy back or swap their bonds at a discount to par value in order to boost capital reserves. This process has been used most extensively in the financial services sector and, typically, these exercises have been undertaken at premiums to prevailing market prices.

Loan to value (LTV) – Expressed as a %, the value of the loan to the value of the assets backing the loan.

LDI – Liability driven investment – Investing in order to match liability cash flows with asset cash flows. This is often achieved using derivatives products to overlay a bond portfolio in order to control duration.

LTRO – Long Term Repo Operation – European Central Bank debt facility to provide 3 year term funding to European financial institutions.

Market value – Market value reflects the value of a security after issuance as influenced by movements in underlying gilt prices and the market's assessment of credit risk. The value of bonds held in the portfolio reflects this market value. Although borrowers typically pay coupons on an annual or semi-annual basis, different treatment of the accrual of coupon payments results in two market value definitions.

> **Market value clean** – Accrued interest is calculated separately and not reflected in the clean market value.
>
> **Market value dirty** – The market value includes accrued interest.

Maturity – Final payment date of a bond, requiring the borrower to repay the bond.

MBS – Mortgage backed securities – An asset backed security (ABS) where cash flows are backed by the principal and interest payments of mortgage loans. RMBS relates to residential MBS. CMBS refers to commercial MBS.

Monoline insurance company – The original business model of the monoline insurers was to provide credit-wrapping (credit insurance) of lower rated bonds by guaranteeing the payment of coupon and principal of the underlying bonds in return for premium payments. This sector had been characterised by decades of unbroken profitability and the consistent maintenance of AAA credit ratings, however, over the past ten years, the focus of the sector shifted from the US municipal market to the credit-wrapping of structured products, such as sub-prime RMBS and CDOs. As losses in these instruments have increased in recent years, concerns have arisen regarding the adequacy of the insurers' claims paying reserves. This has resulted in material rating downgrades within the sector. Following these downgrades, a large majority of credit wrapped bonds are now rated according to the underlying credit quality of the issue rather than the monoline's rating. The main monoline insurance companies are AMBAC, MBIA, FSA and FGIC.

Nominal value – Also known as the face value. It refers to the price of a security when issued. For fixed income assets, nominal value is the product of the number of bonds issued and face value per bond (usually denoted by 1,000). Within the portfolio valuation, nominal value represents a client's holding in a bond expressed at face value**.**

Operation Twist – The name given to the Federal Reserve's monetary policy designed to lower long term interest rates by selling short-term Treasury bonds in its portfolio and buying longer-term Treasury bonds.

Outright Monetary Transactions (OMT) – An unlimited bond-buying scheme aimed at cutting the borrowing cost of debt-burdened eurozone members by buying their short-dated bonds, but only after countries have requested a bailout from the European Central Bank. The scheme was announced in September 2012.

PFI – Private finance initiative – Projects that involve the provision of assets for the public sector by private companies. For instance, the Octagon PFI involves the design, financing, construction and operation of Norfolk & Norwich Hospital by a private company for the Norfolk & Norwich NHS Trust.

Quantitative easing – In March 2009, the Bank of England (BoE) announced its intention to purchase UK government bonds (primarily medium dated UK government bonds) by creating new money (effectively printing money, but electronically). The process was subsequently paused by the Band of England during the first quarter of 2010 and later restarted in the fourth quarter of 2011. This process of purchasing assets through 'printing' money is called quantitative easing (QE).

Redemption yield – The annual interest rate on a bond including any capital gain or loss if it were held to redemption and assuming that all coupon and principal payments are made. If the coupon rate exceeds the redemption yield, then the bond will experience capital loss as it approaches maturity and vice versa.

Sale & leaseback – A process by which a company sells an asset then leases it back.

Securities Market Program (SMP) – A monetary policy tool aimed at providing market liquidity by allowing the European Central Bank to purchase distressed government bonds of peripheral European countries.

Seniority/subordination – Represents a bond holder's relative claim on the assets of an issuer before or after default.

Structured bonds – Bonds issued by a legally separate structure and secured on assets. The structure is often tranched, with different credit ratings for different levels of seniority. The process of issuing structured bonds is often referred to as securitisation.

Sub-investment grade – A credit rating that is below BBB-, also referred to as high yield or junk.

Sub-prime – Riskier mortgage lending to non-prime borrowers.

Supranationals – International non-government agencies/institutions such as the European Investment Bank and the World Bank.

Swaps – A derivative product representing an agreement to exchange one series of cash flows for another.

> **Interest rate swaps** – Exchange fixed cash flows for floating cash flows or vice versa.
>
> **Inflation swaps** – Exchange inflation index linked cash flows for conventional cash flows or vice versa.

Swaption – This derivative gives the holder the option (a right but not an obligation) to enter into an underlying swap.

Tracking error – Defined as the standard deviation of the fund's excess return over the benchmark index return, and generally quoted as an annualised figure based on monthly observations. This measure quantifies how closely the portfolio's return pattern follows that of a benchmark index. It is an important concept in risk measurement, and is used as both an ex post (historic) and ex ante (expected) measure. RLAM employs systems that allow us to estimate the ex ante tracking error of a portfolio.

Underwriting – The process by which an underwriter guarantees the new issue of securities (equity or bond).

Unrated bonds – Bonds that are not rated by any of the rating agencies; traditionally, unrated bonds benefit from security over the assets of the issuer. Unrated bonds are assigned an internal rating by RLAM.

Yield – Interest rate earned on a bond, expressed as an annual percentage.

Yield curve – The relation between the interest rate and the time to maturity of a bond.

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

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

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

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

Portfolio Valuation

As at 31 December 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									
	137,545,790	RLPPC Over 5 Year Corp Bond Pen Fd	1.99876	172,072,058.29	274,921,022.66	0.00	274,921,022.66	0	100.0
			Funds Held total	**172,072,058.29**	**274,921,022.66**	**0.00**	**274,921,022.66**		**100.0**
			Grand total	**172,072,058.29**	**274,921,022.66**	**0.00**	**274,921,022.66**		**100.0**

Trading Statement

For period 01 October 2014 to 31 December 2014

Dorset County Pension Fund

	Trade Date	Transaction Type	Nominal	Security	Price (£)	Book Cost (£)
Acquisitions						
Funds Held						
	07 Oct 2014	Acquisition Rebate	86,929.51	RLPPC Over 5 Year Corp Bond Pen Fd	1.95	169,265.67
	07 Oct 2014	Acquisition Rebate	249.38	RLPPC Over 5 Year Corp Bond Pen Fd	1.93	481.71
					Funds Held total	**169,747.38**
					Acquisitions total	**169,747.38**