DORSET COUNTY PENSION FUND

Quarterly Report 31 March 2015

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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 March 2015	**286.13**
31 December 2014	274.92
Change over quarter	11.21
Net cash inflow (outflow)	0.00

ROYAL LONDON

EXECUTIVE SUMMARY

Performance

- Your fund gave a return of 4.08% over the quarter, compared with a benchmark return of 3.97%.

The economy and bond markets

- UK GDP growth was revised up to 0.6% for the final quarter of 2014, and 2.8% for 2014. Consumer Price Index (CPI) inflation fell to an all-time low of 0.0% year-on-year in February. The Bank of England kept the base rate at 0.5% with all members of the Monetary Policy Committee once again in agreement on maintaining rates at the current level.
- US economic data, although mixed, suggested continued forward momentum. However, with inflation remaining below the Federal Reserve's longer-term objective, the FOMC have remained cautious in their monetary policy signals to the market. Economic data in the eurozone picked up, boosted in part by the low oil price; inflation has remained well below the European Central Bank's (ECB) target. After an announcement in January, the ECB began a new round of quantitative easing, expanding its bond purchase programme considerably, and including government bonds. In China, the government reduced its GDP growth target to 7.0%, while in Japan the economy emerged from recession.
- Conventional gilts returned 2.20% over the quarter; yields were volatile. Medium dated gilts outperformed on a duration adjusted basis. Gilts marginally underperformed other developed markets ahead of the upcoming election. Index linked gilts were very volatile, returning 2.86% for the quarter; longer dated real yields fell to new lows. Breakeven inflation rates fell across shorter maturities but rose marginally at longer maturities following some stabilisation of the oil price.
- Sterling investment grade credit bonds returned 3.20%. Credit spreads narrowed from 1.26% to 1.06%; all sectors outperformed gilts and saw a contraction in credit spreads. Bank debt outperformed the wider credit market, led by subordinated bonds. Weakness in commodity prices again impacted general industrials. Global high yield bonds returned 2.66%.

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 rises 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 -0.90%, seen at the end of March, 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 1.20% p.a. over the next three years.

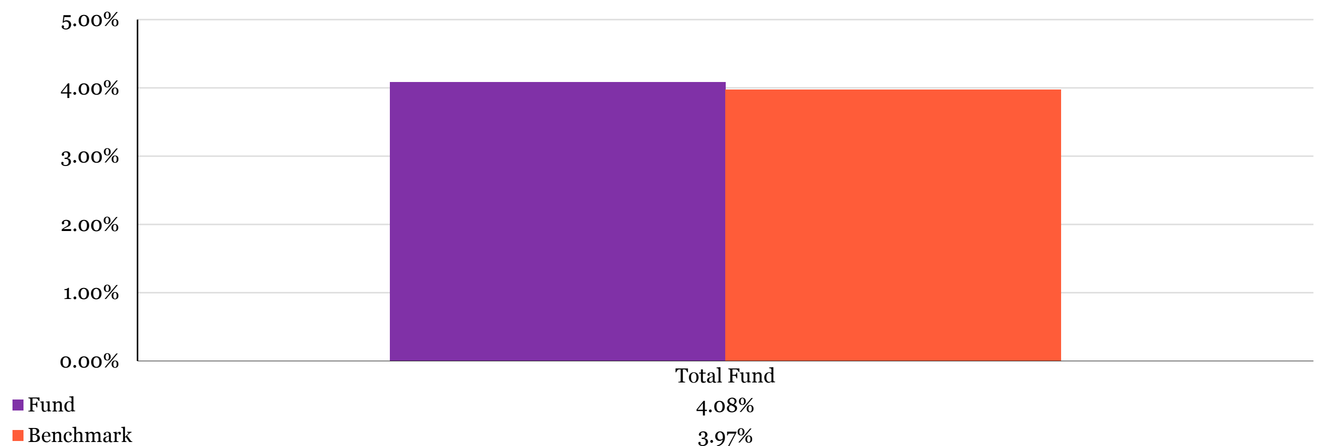
FUND PERFORMANCE

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

Performance

	Fund (%)	Benchmark (%)	Relative (%)
Q1 2015	**4.08**	**3.97**	**0.11**
Rolling 12 months	16.78	16.79	-0.01
Three years p.a.	13.30	11.95	1.35
Five years p.a.	13.46	12.96	0.51
Since inception 02.07.07 p.a.	10.28	10.63	-0.35

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 1 2015

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	10.0 years	10.4 years
Gross redemption yield[3]	3.51%	2.95%
No. of stocks	245	686
Fund size	£287.7m	-

Launch date: 02.07.2007

[1] Benchmark: iBoxx Sterling Non-Gilt Over 5 Year Index.

[2] Conventional credit bond allocation includes exposure to non-sterling credit bonds and CDs, where applicable.

[3] The gross redemption yield is calculated on a weighted average basis.

Figures in relation to the asset spilt table exclude the impact of cash where held.

Performance

	Fund (%)	Benchmark[1] (%)	Relative (%)
Q1 2015	**4.14**	**3.97**	**0.17**
Year to date	4.14	3.97	0.17
Rolling 12 months	17.01	16.79	0.22
Since inception p.a. (02.07.2012)[2]	12.42	10.46	1.96

[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.

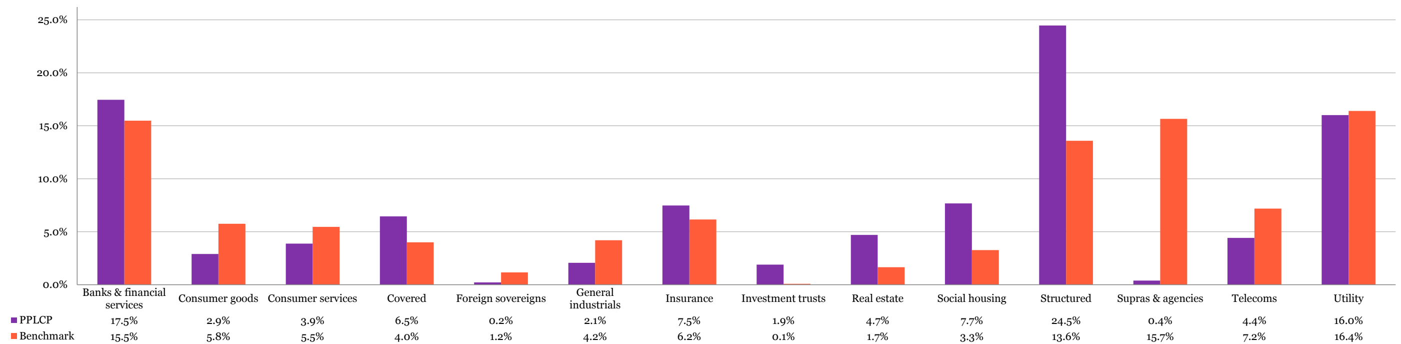
The fund returns in the above table are gross of standard management fees and include the impact of cash holdings over the period.

ROYAL LONDON

RLPPC UK OVER 5 YEAR CORPORATE BOND FUND

Quarter 1 2015

Sector breakdown



	Banks & financial services	Consumer goods	Consumer services	Covered	Foreign sovereigns	General industrials	Insurance	Investment trusts	Real estate	Social housing	Structured	Supras & agencies	Telecoms	Utility
PPLCP	17.5%	2.9%	3.9%	6.5%	0.2%	2.1%	7.5%	1.9%	4.7%	7.7%	24.5%	0.4%	4.4%	16.0%
Benchmark	15.5%	5.8%	5.5%	4.0%	1.2%	4.2%	6.2%	0.1%	1.7%	3.3%	13.6%	15.7%	7.2%	16.4%

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

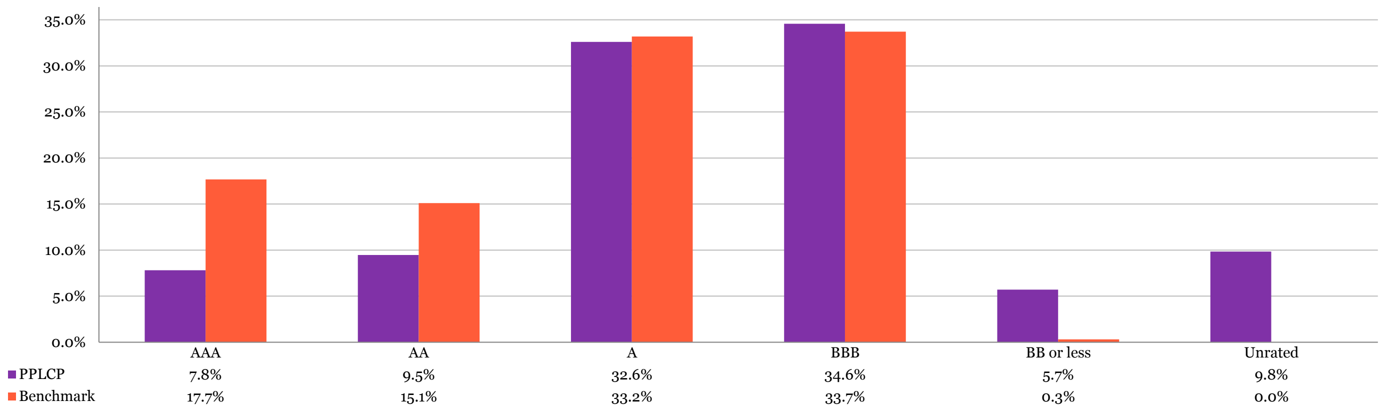
What we thought	What we did	What happened	Effect on portfolio
We expected that medium and long dated corporate bonds would outperform equivalent supranational debt.	We maintained a significantly underweight position in supranational bonds.	Supranational bonds underperformed the overall sterling credit market.	The underweight position in supranational debt had a small positive 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.	Subordinated financial debt outperformed, whilst senior and covered bonds lagged.	The positioning within the financial sector was a small positive 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.	Consumer orientated bonds performed in line with the wider credit market despite the downgrade of Tesco plc to sub-investment grade.	The low weighting in high profile consumer debt was not a material factor in performance.
We continued to believe that secured bonds were undervalued relative to unsecured debt.	We maintained a significant overweight position in sectors that benefit from enhanced security e.g. asset backed securities (ABS), social housing and investment trusts.	Credit spreads in secured and ABS bonds declined by more than the overall market.	The fund's exposure to ABS was marginally beneficial. The position in Tesco debt was not a significant factor in relative performance.

ROYAL LONDON

RLPPC OVER 5 YEAR CORPORATE BOND FUND

Quarter 1 2015

Rating breakdown



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

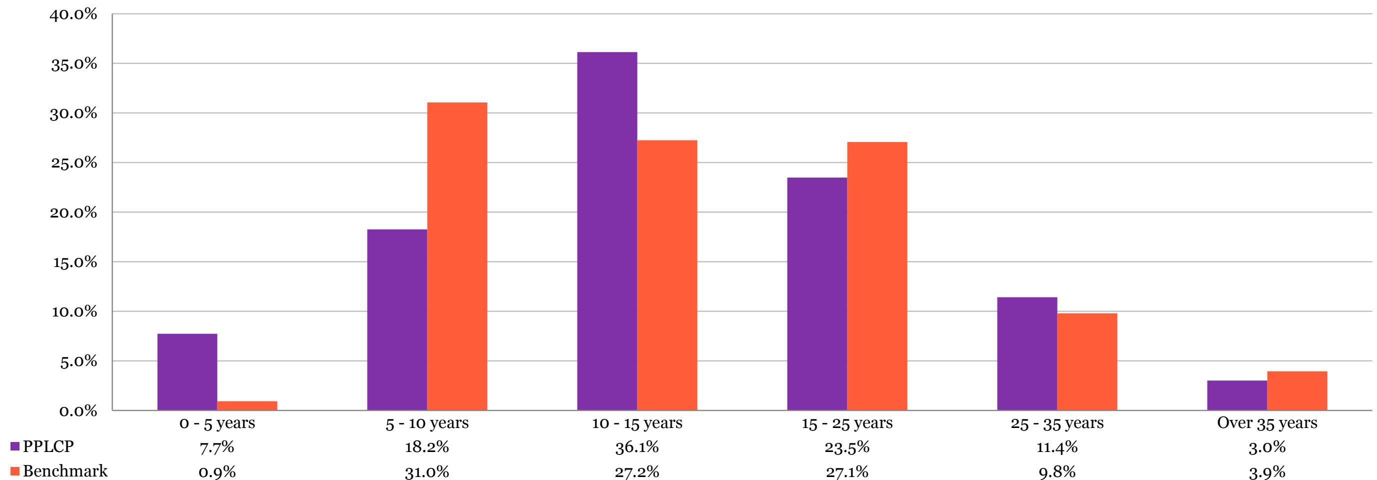
What we thought	What we did	What happened	Effect on portfolio
We believed that lower rated credit bonds offered better value than AAA / AA rated securities.	We maintained an overweight position in BBB and sub-investment grade debt.	BBB debt outperformed, reflecting increased risk appetite in the quarter.	The credit rating profile of the portfolio was beneficial.

ROYAL LONDON

RLPPC UK OVER 5 YEAR CORPORATE BOND FUND

Quarter 1 2015

Maturity profile



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 bond yields would rise in quarter one.	Fund duration was further reduced in the quarter, with an overall bias to be short duration (0.25-0.75 year) versus the benchmark index.	Yields of short dated UK government bonds rose over the quarter. However, in a period of extraordinary volatility, the yields of longer dated bonds fell. The main influences on this move were falls in commodity prices pushing global inflation rates lower, increased concerns about Greece, and the introduction 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.	Mirroring the movements in underlying UK government bonds, long dated credit was the best performing maturity sector as investors sought to extend duration and increase yield.	Yield curve positioning was not a material factor in relative performance.

RLPPC UK OVER 5 YEAR CORPORATE BOND FUND

Quarter 1 2015

Ten largest holdings

	Rating	Weighting (%)
Lloyds Bank Plc 6% 2029	AAA	1.4
Annington Finance 0% 2022	AAA	1.1
Finance for Residential Social Housing 8.369% 2058	A-	1.0
Great Rolling Stock Co Plc 6.875% 2035	BBB	1.0
Equity Release Funding 5.88% 2032	A	1.0
Co-Operative Bank 4.75% 2021	BBB-	1.0
Equity Release 5.7% 2031	A	1.0
Abbey National Treasury 5.75% 2026	AAA	0.9
Bank of America 7% 2028	A-	0.9
ENEL Finance 5.75% 2040	BBB	0.9
Total		**10.2**

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

ROYAL LONDON

RLPPC UK OVER 5 YEAR CORPORATE BOND FUND

Quarter 1 2015

Fund activity

- A short duration stance at the overall portfolio level was maintained throughout the quarter; this reflected our view that long term interest rates would rise during 2015.
- Activity in the credit segment of the fund remained low. Although issuance in the primary market was relatively subdued during the period, the fund participated in several attractive opportunities. New bond purchases were focused in the utility and social housing sectors and included:
  - **APT Pipelines**, the largest gas transmission business in Australia. APT has a very stable business profile, with a majority of its earning arising from long dated take or pay contracts. Continued high expansionary capital expenditure provides a strong rationale for maintaining the firm's credit ratings, with high margins and low maintenance capex, giving the business significant financial flexibility. Following the purchase of a new pipeline, APT issued USD 4 billion of bonds across GBP, USD and EUR markets. The acquisition was approached in a creditor friendly way, consulting with the rating agencies and raising equity to maintain their financial profile. The bond was issued at a yield premium of 1.42% over UK government bonds.
  - **Gwynt Y Mor**, an electricity transmission business connecting a Welsh wind farm to the National Grid, operating under the Offshore Transmission Operator (OFTO) regulatory regime. This new regulatory framework gives the business good visibility over revenues for the life of the bond. There is no volume or price risk, with revenue only varying if availability falls below a certain threshold. The bond is amortising, reducing the gearing in the structure over time, with an inflation linked swap ranking pari passu to the bond. The bond was issued at a yield of 1.10% above the benchmark gilt, offering a 0.10% pickup to an existing bond under the OFTO regime.
  - **Paragon**, a social housing provider managing over 9,000 homes across the South East of England. Due to its geographic exposure, Paragon has attractive assets, and the association also benefits from good credit metrics, leading to a strong rating from regulators; the bonds offered a credit spread over the yield of an equivalent UK government bond of 1.40%.
  - **SSE**, an integrated utility operating across generation, transmission, distribution and supply, with 40% of operating profits derived from regulated activities. The company issued GBP and EUR denominated hybrid bonds to replace similar securities approaching their first call date (and hence about to lose their equity credit). The GBP denominated bond was issued at a yield premium of 2.58% over UK government bonds, compared to the firm's 2021 senior bonds at 1.80% above UK government bonds.
  - Within financial sectors, and following renewed senior bank issuance in the euro market, **Abbey National** launched a senior operating company five year deal at 0.83% above UK government bonds, in which the fund participated. We continue to prefer operating company debt to bonds issued out of holding company structures, as we believe that they offer greater protection in the event of bank restructuring.
- In the secondary market, we bought several new positions, including **Temasek** and **Swiss Re**, and also added to existing exposures in bonds from **Friends Life** and **Punch Taverns**.
- Sales were undertaken in a broad variety of sectors; key sales included: **Veolia, Lloyds Banking Group, Aviva, Wal-Mart, Barclays, BNP, Standard Chartered, Abbey, BUPA, Petrobras** (a Brazilian oil company) and **Tesco Property**. In most cases, sales reflected either strong relative performance or duration considerations although, in the case of the latter two issuers, recent downgrades have resulted in the bonds falling below investment grade and therefore they have been removed from the fund's benchmark index. We have reviewed both exposures and decided to retain a significant proportion of our positions, although we have pared back on both. Tesco Property, at the end of the quarter, represented 1.17% of the fund; we believe that the current yield spread over gilt yields of 3.5% adequately reflects the risks but this will be kept under review as we monitor underlying sales performance. At the end of the quarter, Petrobras represented 0.19% of the fund.

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 stance versus the benchmark, as we expect underlying gilt yields to rise in 2015.
- 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

- The global economy continued to grow during the quarter, supported by very easy monetary conditions and cheaper oil.
- Economic data suggested a pickup in eurozone momentum, although inflation remained very low.
- The US Federal Reserve (Fed) further opened up the possibility that interest rates will rise in 2015.

Growth

- The global economy continued to grow during the quarter, supported by very easy monetary conditions and cheaper oil. There were, however, contrasting trends in economic data across the major economies.
- US economic data was mixed during the quarter; the main business surveys and labour market trends continued to suggest forward momentum. However, some consumer and investment related data weakened. Employment grew by 260,000 on average per month in the six months to March, while unemployment continued to fall. Inflation has been running well below the Fed's longer-term objective, and the FOMC have remained cautious in their monetary policy signals to the market.
- Eurozone gross domestic product (GDP) grew by 0.3% qoq in the final quarter of 2014, with the latest Purchasing Managers' Indices (PMIs) pointing to a further pickup in quarter one. Strengthening business confidence has been a feature of recent economic data, boosted in part by the low oil price, as the eurozone is a large net importer of energy. Headline Consumer Price Index (CPI) inflation has remained far below the European Central Bank's (ECB) definition of price stability of inflation below, but close to, 2%. The ECB announced an extension to its asset-purchase programme in January, amounting to EUR 60 billion per month, which will run until at least September 2016.
- Early estimates suggested that the UK economy grew by 0.6% in quarter four 2014, while the most recent business surveys (including PMIs) suggested that positive momentum continued into quarter one. Average annual GDP growth for 2014 was 2.8%, close to our base case assumption, although early estimates of GDP are always prone to revision. The annual rate of inflation fell to a record low, supporting real household income growth.
- In China, the government reduced its GDP growth target from 7.5% to 7.0%, although recent economic news has been somewhat softer than this. Monetary and fiscal measures to support growth have been balanced with ongoing economic reform. In Japan, the economy emerged from recession in the final quarter of 2014, supported by a weaker yen and lower oil prices. The underlying picture for demand is still soft however, and the economy has been impacted by the slowdown in China.

Inflation

- UK CPI inflation fell to 0.0% year-on-year in February, reflecting a sharp decline in fuel prices, lower food price inflation, and the lagged effect of sterling appreciation.
- Survey-based measures of inflation expectations also fell, while wage pressures showed some modest signs of improvement.
- These trends were repeated in other developed economies; in the US, CPI inflation fell to 0.0%, while eurozone CPI inflation is -0.1%.

Interest rates

- At the beginning of the year, the ECB announced that it would expand its asset purchase programme to include sovereign bonds. Meanwhile the US Fed altered its forward guidance to open up the possibility of a rise in the Fed funds rate as early as June, although they remain cautious on the timing of any move.
- In the UK, the Monetary Policy Committee (MPC) kept the bank base rate at 0.5%, with the February Inflation Report suggesting that a rise in interest rates was still some way off. Although once again voting unanimously to maintain interest rates at the current level, the committee is split between those who believe that a rate rise is more likely than not, and at least one member who believes that a rate cut is equally as likely as a rate increase. The MPC has indicated that any rise in interest rates would be gradual and to a level materially below pre-crisis norms.

Currencies

- Trade weighted sterling rose during the quarter, as weakness versus the US dollar was offset by strength against the euro. On a trade weighted basis, sterling now stands 15% above the low in quarter one 2013.
- The main currency theme of the quarter was continued dollar strength and euro weakness, with the ECB's quantitative easing programme the main driver.

ROYAL LONDON

BOND MARKET REVIEW

Investment grade: financial & corporate bonds

Key points

- Sterling investment grade credit bonds returned 3.20% in quarter one. The high absolute return reflected both a fall in long dated interest rates and a contraction in credit spreads.
- Credit spreads, the average yield differential between sterling investment grade credit bonds and gilts, declined from 1.26% to 1.06%. There was more variation in sector performance than has been the case in recent quarters.

Credit spreads

- In quarter one, sterling investment grade credit bonds returned 3.20%, outperforming UK government bonds by 1.59%, duration adjusted.
- Credit spreads contracted, with the average yield differential between sterling investment grade credit bonds and gilts falling by 0.20% to end the quarter at 1.06%. All sectors saw a contraction in credit spreads.
- Credit spreads remain wider than levels consistent with the long run corporate default rate.

Financial sectors

- Bank debt outperformed the wider credit market; subordinated debt gave the highest return with tier 1 and lower tier 2 bonds returning 3.82% and 4.11%, respectively, as they benefitted from significant credit spread compression (0.36% and 0.29% respectively). Senior bank debt lagged, reflecting strong performance in past quarters and their relatively low credit spreads. Similarly, covered bonds also recorded underperformance against the wider credit market, returning 2.75% with credit spread compression of 0.12%.
- Insurance was one of the strongest sectors, delivering a return of 3.96%.

Non-financial sectors

- All sectors outperformed gilts over the quarter, reversing the underperformance seen in the second half of 2014; real estate recorded the highest excess return. Weakness in commodity prices again impacted general industrials, although the sector still outperformed government bonds on a duration adjusted basis. Retail orientated consumer bonds improved in the quarter, recovering some of the ground lost in late 2014.

Issuance, ratings and maturities

- Sterling bond supply was the lowest since 2000, with issuance down by 43% on the same quarter last year. The main driver for the decline was the fall in non-financial issuances as borrowers looked to the euro market, where funding costs were considerably lower.
- Sterling supply was evenly distributed along the maturity spectrum although longer dated issuance was nearly 20% below its historical average. This reflected the emergence of demand for, and consequent supply of, longer dated bonds in euro credit markets.
- Returns were broadly correlated with credit ratings. AAA rated bonds underperformed, returning 2.73% and recording credit spread compression of 0.11%. Conversely, A and BBB rated bonds returned 3.71% and 3.27% respectively, with their average credit spreads narrowing 0.14% and 0.32% respectively.
- By maturity, the lowest returns were recorded by the shortest dated bonds, reflecting their relative lack of interest rate sensitivity. However, credit spread compression did not vary significantly across the maturity spectrum, giving rise to the highest excess returns in long dated bonds.
- The downgrade of Tesco to sub-investment grade removed one of the largest issuers of sterling debt from investment grade indices.

Outlook

- The challenges within sterling fixed income markets, highlighted in the last quarterly report, remain in place: the UK general election, monetary policy of the ECB and potential rate rises in several developed economies. In addition, liquidity in global credit markets remains significantly below levels prevailing prior to the financial crisis. We believe this will continue and that investment strategies by the wider investor community will need to adapt, with less emphasis on trading and more emphasis on seeking out long term value and lower turnover in portfolios, an approach consistent with our long held views regarding the managing of credit.
- Despite outperformance in the quarter, we believe that the pricing of credit bonds still undervalues the asset class, relative to government bonds. We expect that investment grade credit bonds will outperform UK government securities by approximately 1.20% p.a. over the next three years.

ROYAL LONDON

BOND MARKET REVIEW

Conventional government bonds

Key points

- Conventional UK government bonds returned 2.20% in the quarter.
- The Bank of England (BoE) Monetary Policy Committee left its policy rate and quantitative easing unchanged at 0.5% and £375bn, respectively. The MPC minutes highlighted a return to a unanimous 9-0 decision as two members pulled back from voting for a 0.25% interest rate rise. The majority felt that the situation in Europe and low inflation justified no change.
- The UK Consumer Price Index (CPI) inflation rate fell to 0.0% in February for the first time. Fourth quarter gross domestic product (GDP) was revised up from 0.5% to 0.6%, resulting in average annual GDP growth for 2014 reaching 2.8%, the highest pace of annual growth since 2006.
- The UK Debt Management Office (DMO) announced GBP 133.4 billion gilt and GBP 7 billion T-Bill issuance in 2015/16. This will be split GBP 33.9 billion (25.4%) of short dated, GBP 26.7 billion (20.0%) of medium dated and GBP 37.4 billion (28.0%) of long dated gilts, as well as GBP 31.4 billion (23.5%) of index linked gilts. GBP 105.2 billion will be by auction, GBP 24.2 billion by six syndications and GBP 4 billion by mini-tender, with maturities as yet to be decided.
- On a duration adjusted basis, medium dated gilts outperformed short and long dated gilts as the market rallied on subdued oil prices and concern that European quantitative easing would drive yields lower. Gilts marginally underperformed both US and Europe over the quarter.

Variation of return across the UK market

- Overall, the conventional UK government bond market returned 2.20% over the quarter, with short dated gilts returning 0.56%, medium dated gilts 1.68%, and long dated gilts 4.11%. Gilts marginally underperformed in a global context ahead of the upcoming election.
- 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 low investor participation in auctions, with no syndications until June and an election in May. The yield curve flattened between 30 and 50 years as ultra-long dated supply was limited.
- At the end of the quarter, the DMO announced the issuance schedule for the upcoming quarter, which will be spread across maturities with two short, three medium and two long dated auctions, with the surprise being no ultra-long issuance and no syndications until after the election.

Overseas fixed interest markets

- Yields in core overseas markets fell over the quarter; peripheral eurozone markets (e.g. Italy and Spain) outperformed, as the European Central Bank (ECB) started its sovereign quantitative easing programme, but reversed some of these gains later in the period.
- German government bond yields fell to new all-time lows, with two year and five year maturity bonds trading at negative yields. Bund yields are now well through current Japanese government bond yields. The ECB maintained the policy rate at 0.05% and the deposit rate at -0.20%.
- The ECB expanded its bond buying programme to cover government bond markets, with a target of EUR 60 billion of purchases per month until at least September 2016, implying a minimum total of EUR 1.1 trillion of purchases.
- US ten year government bond yields declined to 1.92% as the strong economic growth started to slow a little. However, it was difficult to know how much of this could be explained by recent bad weather.

Outlook

- We expect global government bond yields to trend higher from current levels, as economic data continues to improve and we move closer to rate hikes from both the US Federal Reserve and the Bank of England. Our base case assumes a very gradual rise in policy rates, so we do not expect a dramatic sell-off in government bond markets over the next twelve months.
- Our central case is for UK government bond yields across maturities to rise over 2015, and for the yield curve to flatten, 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 upward force on yields as the latest flight to safety abates.

ROYAL LONDON

BOND MARKET REVIEW

Index linked bonds

Key points

- Index linked gilts returned 2.86% as real yields fell to record lows.
- Index link bonds were very volatile, reflecting the "feast or famine" nature of the market; long dated real yields traded within a range of -0.5% to -1.0% over the quarter.
- Real yields fell across all maturities, globally, on fears of widespread deflation. UK government index linked bonds outperformed their US and Canadian counterparts but underperformed European bonds that were supported by the European Central Bank's (ECB) sovereign quantitative easing programme, which was announced in January.
- UK Consumer Price Index (CPI) inflation fell to 0.0% in February, the lowest rate on record; oil prices fell further with Brent crude ending the quarter 8.5% lower.
- Breakeven (implied) inflation rates at the short end of the market fell as inflation expectations declined. Longer dated breakeven rates ended the quarter marginally higher as longer term inflation expectations improved as the oil price stabilized.

Real yield and breakeven (implied) inflation curve moves

- Real yields fell over the quarter, with long dated real yields reaching a record low of near -1% in mid-January, and ending the quarter close to this level. This masked a volatile quarter where real yields rose sharply in February by around 0.50% before falling again into the end of the quarter. 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 at shorter maturities declined over the quarter as CPI inflation fell to its lowest level on record. The fall in implied inflation was greatest in the five year sector, where breakeven inflation rates declined by 0.22%. Longer dated breakeven rates rose marginally as longer term inflation expectations improved, following some stabilisation of the oil price.

Variation of return across the UK market

- The real yield differential between ten and thirty year bonds fell by around 0.10%. In yield terms, the fifty year sector was the best performing sector, with real yields falling by around 0.23% over the quarter.
- The FTSE Index Linked Gilts All Stocks Index returned 2.86% over the quarter, giving a twelve month return of 18.55%. Index linked gilts posted positive returns across all maturities over the quarter; the best performing area was ultra long dated bonds with returns in excess of 10%.

Overseas and credit index linked market

- The UK market outperformed the US and Canada but underperformed European bonds that were supported by inclusion in the ECB's sovereign quantitative easing programme, which was announced in January.
- 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 -0.9%, as seen at the end of March, are too low and do not reflect long term economic fundamentals.
- Pension fund demand for longer dated real yield securities remains strong but is becoming more sporadic, and long dated real yields at current levels are very dependent on pension fund demand. This was apparent as there were fewer LDI buyers in February and real yields rose by around 0.5%. With the outcome in the upcoming election uncertain, it would not be a surprise if long term hedging strategies are delayed, as was the case prior to the Scottish referendum. We therefore believe US and Canadian bonds offer better value than gilts, with real yields approximately 1.5% and 1.1% higher, respectively, than those of the UK.
- We believe that long dated breakeven inflation rates of 3.2% are above fair value. However, with the oil price stabilising, shorter dated breakeven rates look attractive against longer term inflation expectations.
- We believe that 10 and 30 year UK government real yields will rise towards 0.1% during 2015, significantly higher than current levels.

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BOND MARKET REVIEW

Overseas government bonds

Key points

- Global bond yields declined significantly over quarter one 2015, reflecting fears of low growth and deflation and easing of monetary policy in a number of countries. Over the quarter, ten year US government bond yields fell below 2.0%, whilst equivalent German yields fell below 0.20%. The announcement by the European Central Bank (ECB) of its sovereign quantitative easing programme led to peripheral spread tightening, flatter yield curves and an outperformance of inflation linked bonds.
- Growth in the US and UK slowed, partly due to weather effects. However, there were tentative signs of a recovery in Europe. Headline inflation continued to fall as the oil price reached new lows below USD 50 per barrel.
- Easier monetary policy in both Europe and Japan led to the trade weighted dollar index rising by 9% over the quarter.

Yield curve moves over the quarter

- Ten year government bond yields in the UK fell by 0.18%, equivalent US government bonds by 0.25%, while in Germany ten year bonds reached record lows, ending the quarter 0.36% lower. In Japan, yields rose by around 0.08%.
- At the end of the quarter, ten year conventional government bond yields in the US, Germany, Japan and the UK were 1.92%, 0.18%%, 0.40% and 1.58%, respectively.
- Real yields reflected the moves of conventional bond yields but were also supported towards the end of the quarter as the oil price stabilised somewhat. Real yields in Europe fell sharply as inflation bonds were included in the European Central Bank's (ECB) quantitative easing programme, with 10 year German real yields falling by 0.70% over the quarter.
- As a consequence of the stabilisation of the oil price, breakeven (implied) inflation rates rose globally, with 10 year breakeven rates in Europe 0.40% and in the US 0.10% higher.

Currency markets

- The US dollar continued to be the strongest currency as both the ECB and Bank of Japan eased monetary policy further. Conversely, the US Federal Reserve (Fed) took a more hawkish tone, signaling a change in its forward guidance on interest rates.
- Over the quarter, sterling was marginally stronger 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. 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 still 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 bonds 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 2.76%; monthly returns were volatile over this period (January 0.72%, February 2.25%, March -0.21%).
- Telecoms (3.53%) and retail (3.35%) sectors outperformed; basic industry (2.23%) and healthcare (2.37%) lagged.
- Global new issuance in the quarter was over $106 billion, up 27% on the same period last year and due primarily to a high level of issuance during February and March, owing to the stronger market.
- The index yield ended the quarter 0.31% lower at 5.62%, with the average high yield credit spread tightening by 0.11% to 4.56% 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 was the weakest performing region returning 2.41% for the quarter. Credit spreads tightened by 0.20%, while underlying government yields fell by 0.25%.
- Europe outperformed, returning 3.04%; spreads tightened by 0.17%, while underlying government yields fell by 0.19%.
- Emerging Markets returned 2.51%, with credit spreads tightening by 0.74%, while government yields fell by 0.27%.

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

Monthly performance

- January began with softness across markets as oil prices fell below $50 per barrel and the World Bank cut expectations of eurozone GDP and inflation growth. As the month progressed, markets were taken by surprise as the Swiss National Bank decided to de-peg the Swiss franc, leading to an instant 29% appreciation against the euro. Finally, the European Central Bank (ECB) announced a larger-than-expected quantitative easing programme of €60 billion per month through September 2016, while Greek elections saw the "anti-austerity" party Syriza gain power. January witnessed no less than 13 central banks (covering 31 countries) implementing easing policies, while five countries saw a tightening of monetary policy.
- In February, growing uncertainties about the approaching deadline for Greece's bailout programme appeared and strong US payroll numbers stoked fears of a rate rise. As the month progressed, concerns gradually subsided on the geopolitical front with a cease-fire agreement reached in Ukraine. As the month came to an end, eurozone finance ministers agreed to extend Greece's financing by four months, suspending speculation of Greece exiting the eurozone. February was a strong month for risky assets as market concerns eventually abated, highlighted by new highs reached by the S&P 500 and the Dow indices, and helped as oil prices stabilised on the back of speculation over falling rig counts and refinery strikes. February was also the month that saw Petrobras downgraded to high yield, set to instantly become the largest name in the index.
- March saw three consecutive record weeks of inflows in European High Yield funds, adding more than $3 billion and bringing YTD inflows to in excess of $6 billion. The start of the ECB's quantitative easing programme, strong inflows in Europe, and market concerns in the US of a potential early rate rise from the Federal Reserve (Fed) contributed to the outperformance of Europe. As March progressed, US concerns gradually subsided, as despite the removal of the word "patience" around rate hikes in the Fed's statement, the latter was perceived as dovish by investors. The last Budget of the current UK government was seen as broadly neutral by the market, while potential policy support appeared in China after the People's Bank of China chief mentioned the slowdown in growth and suggested the central bank had scope to respond.

Ratings & maturities

- B rated bonds outperformed BB rated bonds over the quarter, returning 2.87% and 2.68%, respectively. Outside of the benchmark index, the Global High Yield CCC & Lower index returned 0.97%.
- Returns for the quarter were worse at shorter maturities. Returns were 1.96% for 0-3 years, 2.10% for 3-5 years, 2.80% for 5-7 years, 3.09% for 7-10 years and 5.61% for over 10 years.

Outlook

- We expect the strength 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 some time, as the effects of the sharp decline in commodity prices continue to 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, an improvement in eurozone growth, and growth of c.7% in China, where low inflation will enable further policy easing.
- We expect average annual US gross domestic product (GDP) growth of c.3% in 2015, with output rebounding in quarter two after being hit by severe weather and a ports labour dispute. 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 for an improvement in economic conditions; we have raised our base case growth forecast to 1.5%, from 1.0%. 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 will create some uncertainty, which may impact consumer and business confidence. However, we believe that continued global economic growth will support activity in the UK.
- In China, we expect GDP growth close to the new official target of 7%, as the authorities use selective policy easing measures to support activity. 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 risks 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 some time to come, 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 will 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.
- The 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 2015/16. Global economic headwinds remain, with the imbalance between global savings and investment flows requiring lower equilibrium 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 have reflected a perception that central bank policy rates will remain lower than previously expected and the advent of European Central Bank sovereign quantitative easing. The latter has created distortions in valuations: at current yield levels, markets appear to discount a very bearish view of global growth prospects. 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 1.20% p.a. over the next three years.

ROYAL LONDON

SPECIAL TOPIC

Eurozone QE

March 2015 marked six years from the peak of the financial crisis and the point at which the Bank of England (BoE) lowered its policy rate to its current level of 0.5%. The US Federal Reserve (Fed) and European Central Bank (ECB) lowered their respective policy rates around the same time. And all three have now engaged in quantitative easing.

The timing of their respective quantitative easing exercises most obviously sets them apart from one another. The Fed undertook multiple rounds of asset purchases, beginning in November 2008, purchasing a total of USD4.5 trillion of assets, followed by the BoE beginning in September 2009, purchasing GBP375 billion of assets. Both the US and UK have now finished (or, at least, are not currently purchasing assets).

Only in March 2015, after much anticipation and an announcement in January, did the ECB begin its own quantitative easing programme, initially targeting at least EUR1.1 trillion of purchases. The announced programme was viewed as being the "whatever it takes" that Mario Draghi referred to in a statement he made in the heights of the eurozone sovereign debt crisis, in July 2012, at which point the future of the eurozone looked in doubt.

Details

The Governing Council of the ECB announced its anticipated quantitative easing programme in January. Details of the programme included:

- EUR60 billion purchases a month until September 2016 at least or until the ECB "…see a sustained adjustment in the path of inflation, which is consistent with our aim of achieving inflation rates below but close to 2% over the medium term."
- EUR6-7.2 billion of purchases will be in supranational debt, EUR12 billion in covered bonds and ABS, leaving EUR40 billion a month in government bonds and agencies
- Government bonds will be bought in line with the Capital Key of Europe; EUR11 billion in Germany, EUR8.5 billion in France, and EUR7.3 billion in Italy.
- Each country's National Central Bank (NCB) will be responsible for the purchasing of the government bonds and will be held at their own risk; there is no risk sharing for the majority of the programme.
- Purchased debt will have maturity between 2 and 30 years and will include negatively yielding debt.
- Inflation linked debt is eligible. Limits on the programme include caps at 25% of each issue and 33% of the debt of each country.
- All securities bought will be made available for securities lending.

Reaction

Immediate reaction to the announcement in January was a sharp fall in eurozone government bond yields, with the yield of 10 year maturity German government bonds falling from 0.53% to 0.36% over two days following the announcement. The concept of risk sharing was seen as key to the long term success of the eurozone; in the words of BoE governor Mark Carney, its absence puts the eurozone in an "odd position" in trying to achieve monetary unification without the sharing of fiscal sovereignty. While its absence has so far been ignored by the market, should yields rise and a country get into difficulty, it could have severe implications.

At the start of the program on 9 March, the yield of the 10 year German government bond again fell sharply from 0.39% to 0.23% over two days and, by the end of quarter one had reached 0.18%.

Success of quantitative easing

While the success of quantitative easing in the US and UK is difficult to measure, as it is impossible to say how economies and markets would have done if quantitative easing had not happened, arguably it has delivered some stability to markets globally. However, the problems that the eurozone has been left with are very much its own, evidenced by the weakening single currency. It remains to be seen whether markets will believe in a project that, in order to succeed, needs to be believed in by the markets, and must also transcend the national interests of fiscally independent eurozone members.

Outlook for eurozone growth

Our base case for the eurozone in 2015 is for an improvement in economic conditions; we have raised our base case growth forecast to 1.5%, from 1.0%. Growth is supported by an easing in fiscal policy, lower oil prices, a weaker currency and stronger US growth.

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 and Royal London Asset Management

- Our voting records and the details of how RLAM approaches the stewardship of the securities we hold on behalf of our clients are disclosed on our website: www.rlam.co.uk.
- RLAM has a dedicated Governance Team which implements RLAM's Voting Policy across all UK holdings. Our public voting records are fully transparent, searchable and updated on a monthly basis. We also disclose information publicly about our engagement with companies on a quarterly basis.
- RLAM supports the principles of the UK Stewardship Code. Our underlying belief is that management are appointed by the shareholders to manage the business in the best interests of shareholders over time. While engagement is largely from an equity investors 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 restructuring and in many cases these involve a bond holder vote. We 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.
- All enquiries with respect to our voting and engagement activities should be directed in the first instance to the RLAM Chief Investment Officer.

Responsible Investing

- RLAM is committed to being a responsible investor. This means being a good steward of our client's assets and promoting responsible investment with other stakeholders.
- In 2008, Royal London Asset Management became a signatory to the United Nations Principles for Responsible Investment (PRI), and was an early signatory to the UK Stewardship Code. This set the company on a long-term commitment to making responsible ownership 'business as usual'.
- The aim is to generate sustainable, risk adjusted returns that reflect a wider understanding of what will drive economic performance in the future.
- We seek to understand environmental, social and governance risks and opportunities within the investment process.
- We engage with companies and industry regulators to understand the issues that are most material to their business, and to promote best practice.

Engagement

- Engagement refers to our dialogue with companies, regulators, non-governmental organisations and other agents in the investment chain to support better standards of behaviour, risk management and reform for a more sustainable economy.
- Engagement will normally meet more than one of the following criteria:
- Materiality to investment performance
- Importance to our clients
- Reputational impact
- We track our engagements and report on the outcomes in quarterly public reports and to the PRI.
- We initiate or join collective engagements with other investors where we believe it will be more effective than engaging alone, or to draw attention to a worthy topic.

CORPORATE GOVERNANCE & COMPLIANCE

Sustainable Investing/SRI

- We offer a range of Sustainable Funds that seek to invest in companies well positioned to benefit from products and services that help solve major environmental and social challenges and manage their Environmental, Social and Governance (ESG) risks better than average. This may be through the products and services they offer or by virtue of the fact that while not 'solution' companies in terms of products and services they nevertheless show leadership in their management of ESG impacts.
    - Our suite of Sustainable Funds include:
    - Sustainable World
    - Sustainable Diversified
    - Sustainable Leaders
    - Sustainable Managed Growth
    - Sustainable Managed Income
- We also offer an Ethical Bond Fund and an Ethical Equity Fund aimed at clients that wish to avoid sectors with the highest ethical concerns; namely tobacco, armaments, alcohol, gambling, pornography, nuclear power and animal testing for non-medical purposes. Companies with 10% of revenues or more coming from these activities or those with the worst performance on environmental issues are excluded.

Our relationships with our broker counterparties

- At RLAM, we supported the recommendations in the original Myners Report and the supplementary review of transaction costs.
- We currently deal through approximately 50 brokers globally; a mixture of global firms and regional specialists which enables us to access different information flows and therefore, enhances the overall investment process.
- We undertake a comprehensive broker rating/review process where all brokers used are scored for the quality and utility of their research, dealing abilities, administrative efficiency, accuracy and sales advice. To get a full picture, we involve fund managers, dealers and any comment from the back-office. We do not have soft commission arrangements with any counterparties.

RLAM TEAM

Your fund managers

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Head of Fixed Interest

Paola Binns
Senior Credit Fund Manager

Your dedicated contact

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

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Corporate team changes

In February Rachid Semaoune joined as Credit Fund Manager within the Fixed Income Team. He has 13 years of credit market experience. We also confirmed the hire of Trevor Greetham as Head of Multi-Asset. Trevor joins RLAM in April from Fidelity, where he was Asset Allocation Director.

Distribution team changes

Vathani Waran joined the consultant relations team in January from JLT, with over 15 years' experience spanning consulting and asset management. Prior to joining RLAM she was a lead consulting actuary across all areas of pension investment consulting.

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 March 2015

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									
	137,645,158	RLPPC Over 5 Year Corp Bond Pen Fd	2.07877	172,275,481.03	286,132,625.07	0.00	286,132,625.07	0	100.0
			Funds Held total	**172,275,481.03**	**286,132,625.07**	**0.00**	**286,132,625.07**		**100.0**
			Grand total	**172,275,481.03**	**286,132,625.07**	**0.00**	**286,132,625.07**		**100.0**

Trading Statement

For period 01 January 2015 to 31 March 2015

Dorset County Pension Fund

	Trade Date	Transaction Type	Nominal	Security	Price (£)	Book Cost (£)
Acquisitions						
Funds Held						
	07 Jan 2015	Acquisition Rebate	99,368.27	RLPPC Over 5 Year Corp Bond Pen Fd	2.05	203,422.74
					Funds Held total	**203,422.74**
					Acquisitions total	**203,422.74**