DORSET COUNTY PENSION FUND

Quarterly Report 31 December 2015

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 Benchmark: iBoxx Sterling Non-Gilt Over 5 Year Index.	100.0

Portfolio value

	Portfolio total (£m)
31 December 2015	**277.01**
30 September 2015	276.23
Change over quarter	0.78
Net cash inflow (outflow)	0.28

EXECUTIVE SUMMARY

Performance

- The fund gave a gross return of 0.18% over the quarter, compared with a benchmark return of 0.25%. This brings 2015 performance to 0.66% versus the benchmark of 0.07%
- Over the quarter, UK government bond yields rose, with gilts recording a negative total return. The positive return achieved by sterling investment grade bonds reflected a narrowing of credit spreads. The average yield premium of credit bonds over gilt yields declined from 1.49% to 1.38%.
- A low exposure to supranational debt and underweight positioning in several commodity related bonds helped performance. This was partially offset by underperformance in asset backed securities (ABS) and the real estate sector, as well as a recovery in several long dated utility and telecom bonds where the Fund is underweight.

The economy and bond markets

- Overall global economic growth in 2015 has been weaker than expected. Early estimates suggest that the UK economy grew by 0.4% in quarter three and recent data indicate this momentum continued into quarter four. UK Consumer Price Index (CPI) inflation rose to 0.1% but questions remain about whether the 2% target can be achieved on a 2 to 3 year horizon. The Bank of England (BoE) kept the base rate at 0.5%.
- US GDP growth has been supported by final domestic demand and a robust labour market, culminating in the US Federal Reserve (Fed) raising interest rates for the first time since 2006. Conversely, the People's Bank of China (PBoC) eased policy further; there has been a slowdown in industrial activity and investment, although household consumption has proved to be more resilient. In the eurozone, the European Central Bank (ECB) also loosened monetary policy, extending the region's quantitative easing programme and again reducing its main deposit rate. Eurozone GDP grew by 0.3% quarter-on-quarter, supported by a pickup in export growth and rises in household spending. In most eurozone economies, inflation has been lower than expected for much of the year, driven down by lower commodity prices.
- Conventional gilts returned -1.20% over the quarter; yields rose across all maturities. Medium dated gilts underperformed short and long dated gilts on a duration adjusted basis. Gilts outperformed US treasuries but underperformed European government bonds. In overseas markets, yield moves were volatile; the US underperformed Japan and Europe, whilst within the eurozone, peripheral government bonds outperformed German and semi-core government bonds. Index linked gilts returned -2.89% as the oil price continued to fall and underlying inflation pressures waned; breakeven (implied) inflation rates fell at shorter maturities.
- Sterling investment grade credit bonds returned 0.37%, reflecting a narrowing in credit spreads from 1.49% to 1.38%. Bank debt performed well, with subordinated debt outperforming senior debt, while the insurance sector bounced back having been weaker in earlier quarters. Asset backed and secured bonds lagged the overall market, and whilst Glencore's bonds stabilised, the industrial sector continued to suffer from the effects of lower commodity prices. Returning -0.42%, global high yield bonds underperformed, reflecting continued risk aversion and a sector bias towards US energy companies.

Investment outlook

- Our central case is that the current global expansion will be sustained into 2016.
- We expect global government bond yields to trend higher as concerns about global deflationary pressures ease. 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 -0.64% in the UK, as seen at the end of December, do not reflect long term economic fundamentals.
- While we expect significant challenges in sterling fixed income markets, 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.

The key views within your portfolio

- A significant underweight in supranational bonds, as we expect corporate bonds to outperform over the medium term.
- Duration shorter than that of the benchmark, as we expect underlying gilt yields to rise.
- 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.

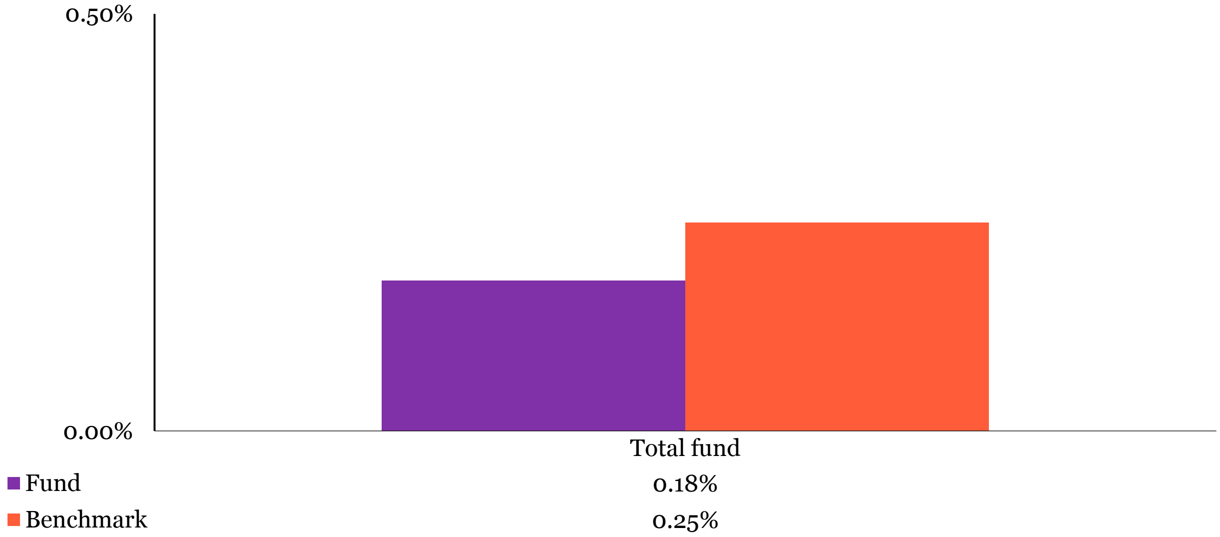
FUND PERFORMANCE

The table below shows the gross performance of your portfolio and the benchmark for the periods ending 31 December 2015:

Performance

	Fund (%)	Benchmark (%)	Relative (%)
Q4 2015	**0.18**	**0.25**	**-0.07**
Rolling 12 months	0.66	0.07	0.59
Three years p.a.	6.40	5.07	1.33
Five years p.a.	10.76	10.26	0.50
Since inception 02.07.07 p.a.	8.90	9.16	-0.26

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 2015

Asset split

	Fund (%)	Benchmark[1] (%)
Conventional credit bonds[2]	99.5	98.8
Index linked credit bonds	0.0	0.0
Sterling conventional gilts	0.3	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	9.5 years	9.9 years
Gross redemption yield[3]	4.08%	3.60%
No. of stocks	298	686
Fund size	£344.3m	-

Launch date: 02.07.2007

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

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

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

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

Performance

	Fund (%)	Benchmark[1] (%)	Relative (%)
Q4 2015	**0.17**	**0.25**	**-0.08**
Year-to-date	0.77	0.07	0.70
Rolling 12 months	0.77	0.07	0.70
3 years p.a.	6.39	5.07	1.32
Since inception p.a. (02.07.2012)[2]	8.61	6.95	1.66

[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.

Past performance is not a guide to future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.

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.

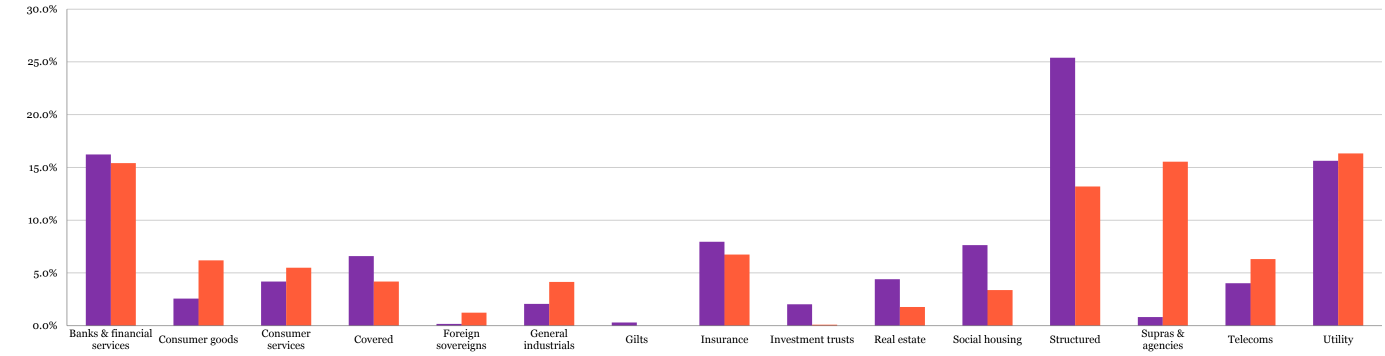
Performance Attribution for Q4 2015

***Source:** RLAM and UBS Delta. The above performance attribution is an estimate. Past performance is not a guide to future performance. The value of investments and the income from them is not guaranteed and may go down as well as up and investors may not get back the amount originally invested.*

RLPPC UK OVER 5 YEAR CORPORATE BOND FUND

Quarter 4 2015

Sector breakdown



	Banks & financial services	Consumer goods	Consumer services	Covered	Foreign sovereigns	General industrials	Gilts	Insurance	Investment trusts	Real estate	Social housing	Structured	Supras & agencies	Telecoms	Utility
Fund	16.2%	2.6%	4.2%	6.6%	0.2%	2.1%	0.3%	8.0%	2.0%	4.4%	7.6%	25.4%	0.8%	4.0%	15.6%
Benchmark	15.4%	6.2%	5.5%	4.2%	1.2%	4.2%	0.0%	6.7%	0.1%	1.8%	3.4%	13.2%	15.5%	6.3%	16.3%

Source: *RLAM as at 31.12.2015. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio.*

What we thought	What we did	What happened	Effect on portfolio
We expected that corporate bonds would outperform supranational debt.	We maintained the underweight position in supranational bonds.	Supranational bonds underperformed as sentiment in investment grade credit markets improved.	Supranational debt exposure had a positive impact on performance over quarter four, but was a small negative over the year.
We continued to prefer a combination of covered bank bonds and subordinated bank debt to senior bonds.	The underweight exposure to senior unsecured bank debt was maintained, offset by above benchmark exposures to covered and subordinated bank debt.	Covered bonds underperformed senior bank debt whilst subordinated debt was one of the strongest performing areas over the quarter and 2015 as a whole.	The benefit of the overweight exposure to subordinated debt was partially offset by the preference for covered bonds over senior bank debt. Overall, positioning in the bank sector was not a material driver of relative performance. Exposure to financials (banks and insurance) over the year was beneficial to performance.
We thought that high profile consumer orientated bonds were unattractively priced relative to corporate debt. We maintained an underweight exposure to industrial bonds.	The underweight exposure to industrial and consumer sectors was maintained.	Industrial sector bonds were again impacted by weakness in commodity prices. However, there was a recovery in the auto sector as the problems at **Volkswagen** were perceived to be stock specific. Consumer bonds performed broadly in line with the wider credit market although the retail sector continued to underperform.	The low weighting in industrial bonds, specifically mining and auto companies, was a positive factor in relative performance for the quarter and over 2015.

RLPPC UK OVER 5 YEAR CORPORATE BOND FUND

Quarter 4 2015

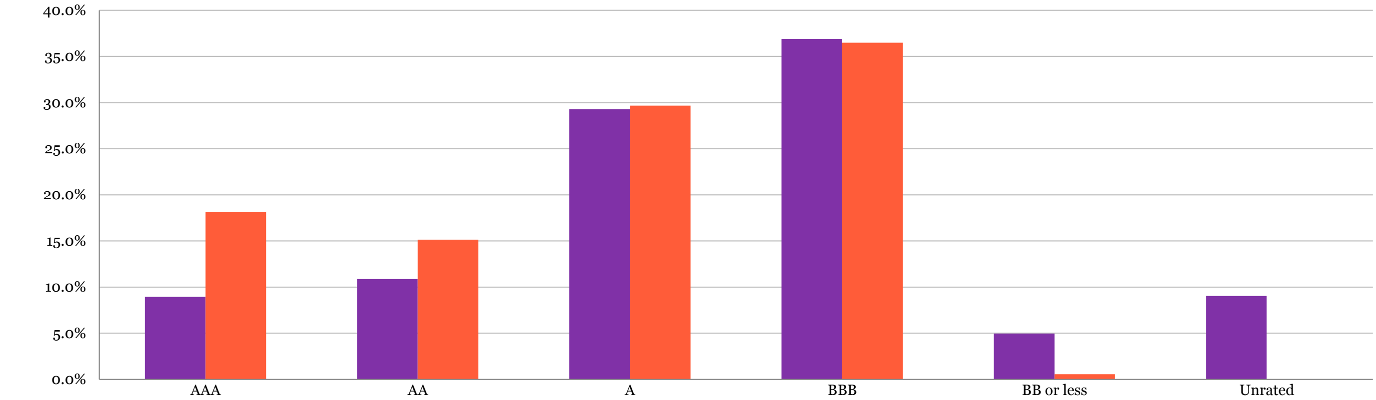
Sector breakdown continued

What we thought	What we did	What happened	Effect on portfolio
We continued to believe that secured bonds were undervalued relative to unsecured debt.	We maintained a significant overweight position in sectors that benefit from enhanced security e.g. asset backed securities (ABS), social housing and investment trusts.	Credit spreads in secured and ABS bonds narrowed over the quarter but generally underperformed the overall market. The Fund retained a 1.17% exposure to structured **Tesco Property** bonds, whose performance remained subdued.	The overweight in ABS was detrimental in the quarter but was a material factor in relative outperformance during the year. Exposure to Tesco Property had a small negative impact on Fund returns.

RLPPC OVER 5 YEAR CORPORATE BOND FUND

Quarter 4 2015

Rating breakdown



	AAA	AA	A	BBB	BB or less	Unrated
Fund	9.0%	10.9%	29.3%	36.9%	5.0%	9.0%
Benchmark	18.1%	15.1%	29.7%	36.5%	0.6%	0.0%

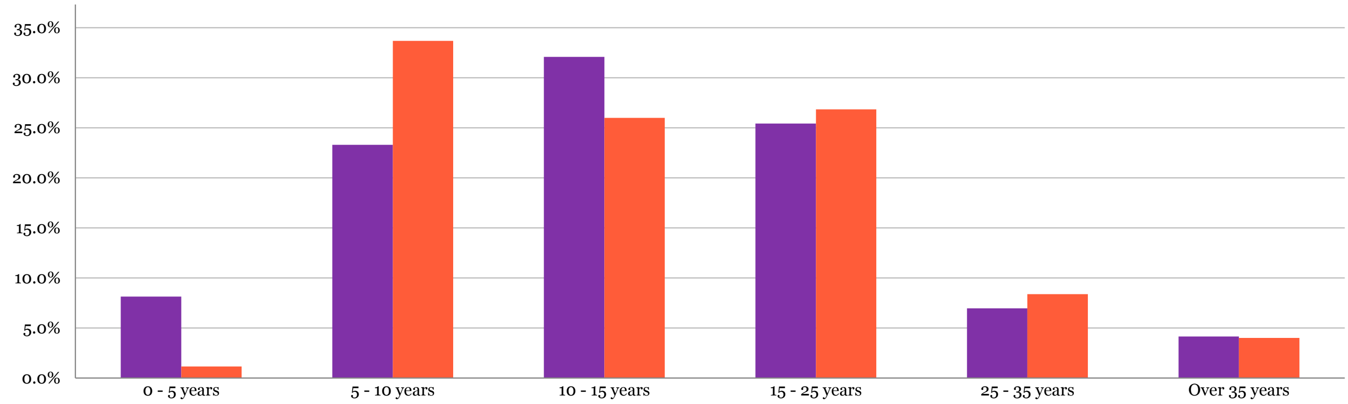
Source: *RLAM as at 31.12.2015. Figures in relation to your portfolio exclude the impact of cash held, although they do include the impact of CDs if held within your portfolio.*

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.	Purchases of insurance and utility bonds over the quarter increased the Fund's overweight position in BBB rated debt.	BBB rated credit bonds outperformed, reflecting their greater sensitivity to the tightening in overall credit spreads in the period.	The credit rating profile of the portfolio was beneficial.
Credit ratings, while useful, are not sufficient in the assessment of creditworthiness and value of corporate bonds.	We retained exposure to bonds rated below investment grade where we believed they were consistent with the overall objective of the Fund. In part this exposure reflected the Fund's holding in the Royal London Sterling Extra Yield Bond Fund. Exposure to unrated bonds, which predominantly have investment grade risk characteristics and are in many instances secured, was broadly unchanged at 9.0%.	Although global high yield debt was weak during the quarter, sterling high yield performed well. This reflected the low exposure to energy and commodity related bonds. The Royal London Sterling Extra Yield marginally outperformed investment grade credit bonds.	Exposure to bonds rated below investment grade helped performance, especially subordinated financial debt. The Fund sold its small position in **Petrobras**. This reflected increased uncertainty about the financial profile of the company and the recent downgrade of Brazil. Exposure to the Royal London Sterling Extra Yield Bond Fund had little impact over the quarter; over the year as a whole the allocation was beneficial.

RLPPC UK OVER 5 YEAR CORPORATE BOND FUND

Quarter 4 2015

Maturity profile



	0 - 5 years	5 - 10 years	10 - 15 years	15 - 25 years	25 - 35 years	Over 35 years
Fund	8.1%	23.3%	32.1%	25.4%	7.0%	4.1%
Benchmark	1.1%	33.7%	26.0%	26.8%	8.4%	4.0%

***Source:** RLAM as at 31.12.2015. 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 UK government bond yields would rise.	The Fund's short duration stance maintained over 2015 was kept within a range of 0.50 to 0.25 years below benchmark.	Yields rose across the maturity spectrum, in part reflecting the Federal Reserve's decision to raise US official rates in December.	The short duration position maintained over the quarter was a small positive factor in relative performance.

RLPPC UK OVER 5 YEAR CORPORATE BOND FUND

Quarter 4 2015

Ten largest holdings

	Weighting (%)
Lloyds Bank Plc 6% 2029	1.3
Commonweath Bank of Australia 3% 2026	1.1
Citigroup Inc 7.375% 2039	1.0
Finance for Residential Social Housing 8.369% 2058	1.0
RWE Finance 6.125% 2039	1.0
Abbey National Treasury 5.75% 2026	1.0
Annington Finance 0% 2022	0.9
Co-operative Bank 4.75% 2021	0.9
Bank of America 7% 2028	0.9
Equity Release 5.7% 2031	0.9
Total	**10.2**

Source: *RLAM as at 31.12.2015. Figures in the table above exclude derivatives where held.*

RLPPC UK OVER 5 YEAR CORPORATE BOND FUND

Quarter 4 2015

Fund activity

- Despite an improvement in market sentiment, liquidity in sterling credit markets continued to be influenced by regulatory pressures on banks, with less capital being devoted to market making of securities, compounded further by a sharp drop in sterling bond issuance in the approach to year end. UK government securities were held during the quarter to aid duration and liquidity management. Nevertheless, new bond issuance early in the quarter offered several attractive opportunities to add new positions to the Fund:
  - Following a period of significant sector weakness, the Fund's underweight position in the industrials area was reduced through the participation in two new bonds from higher quality issuers. **CRH**, the global building materials business with a €20 billion equity market value, issued a BBB+ rated bond at a credit spread of 2.12% over the reference gilt, while **BHP Billiton**, the highest rated global mining company, issued an A-rated corporate 'hybrid' bond offering a 6.5% coupon to its seven year call date.
  - Within the insurance sector, **MetLife**, the large global insurance company, issued AA- rated senior Funding Agreement-Backed Notes. The bonds were attractively priced relative to the company's senior unsecured debt. In addition, exposure to **Legal & General** was increased with the purchase of a new subordinated (tier 2) bond at levels that were significantly better than the issuer's existing debt. The BBB+ rated bonds are callable in 2025 and were purchased at a yield of 3.5% above the reference government bond. Likewise, exposure to **Old Mutual**, the international long-term savings, protection and investment group, was increased. The company issued new 10 year, tier 2 debt at a yield just below 8%, with the bonds designed to help bolster UK Solvency II capital ahead of repayment of other subordinated debt in the quarter. The company, which is regulated by South African authorities (given the issuer's substantial presence in the country), is also regulated in the UK and as such is required to hold capital for its UK business.
- Secondary market activity included adding to several insurance issues, an area of persistent weakness over much of the year; exposure to **Aviva** was increased and a new position established in French insurer **CNP Assurances**. In the banking sector, existing holdings of **Citigroup** and **Standard Chartered** were increased.
- The Fund also added to several secured bonds, including **Telereal** bonds backed by cash flows and assets of telecoms incumbent BT, Premiership football club **Arsenal**, and investment trust **Scottish Mortgage and Trust**. New positions were established in social housing bonds of **Haven Funding** and of **Longstone** bonds backed by long-term lease obligations of retailer Sainsbury.
- Weakness in several utility bonds following the introduction of new regulations by the German government gave the Fund the opportunity to increase exposure to **RWE**, one of the poorest performers of 2015. We also added to **SGSP**, a company that manages utility infrastructure in eastern Australia, and **Yorkshire Water**.
- In December the Fund sold its position in **Scottish Investment Trust** bonds, following an unsolicited approach by the issuer to repurchase some of the outstanding issue. Exposure to **Rabobank** was also reduced, while positions in **Motability** and **Petrobras** were sold. Elsewhere small sales were undertaken to finance new issue purchases.
- Following the acquisition of **Quintain** by private equity group Lone Star, the new owners of the business decided to buy back the strongly covenanted Quintain bonds in order to increase operational and financial flexibility. As per the terms of the bonds, Lone Star were required to pay a price that included a premium of around 25% to par and 15% to the prevailing market level for the bonds. In addition to the clear positive return achieved, we believe this event further underlines the advantage of owning bonds with the strongest credit protections, especially when these protections are under-valued in market prices.
- **RBS** tendered for senior bonds during the quarter, buying back over £3 billion of bonds across multiple currencies. This process reflected the continuing balance sheet reduction of the bank and an opportunity for the issuer to benefit from certain hedging gains, whilst presenting an opportunity to sell holdings at an attractive premium to the prevailing market price.

Key views in your portfolio

- A significant underweight in supranational bonds, as we expect corporate bonds to outperform over the medium term.
- Duration shorter than that of the benchmark, as we expect underlying gilt yields to rise.
- A bias towards asset backed securities, an area that we believe still offers the best risk/return characteristics.
- An overweight position in subordinated financial debt, where we believe yields are attractive.
- Targeted exposure to higher yielding bonds through investment in the Royal London Sterling Extra Yield Bond Fund.

ECONOMIC REVIEW

Key points

- Since September, global activity news has been mixed, with overall global economic growth in 2015 weaker than expected, thanks to negative surprises in the Emerging Markets block.
- In the US, GDP growth has been supported by final domestic demand, employment levels have continued to rise at a reasonably robust pace, and the unemployment rate has fallen to 5.0%. In China, there has been a slowdown in industrial activity and investment, with household consumption remaining more robust.
- The eurozone economy continues to be a major beneficiary of the shift in the terms of trade between energy producers and consumers, and is the one major economy where we have upgraded our GDP growth forecast during 2015. GDP grew by 0.3% quarter-on-quarter in quarter three 2015, supported by a pickup in export growth and rises in household spending, which in turn has been boosted by falls in energy prices.
- Early estimates suggest that the UK economy grew by 0.4% in quarter three 2015, while the most recent business surveys suggest that the economy continued to expand at a similar pace in the final quarter of the year. The major contributions to growth in quarter three were household consumption and stock building, with net trade a significant drag. On the income side, growth in household real disposable income (4% year-on-year) is supporting consumption.
- In most economies, inflation has been lower than expected for much of 2015. Lower commodity prices have been a major factor driving down headline inflation. However, these need to keep falling or the year-on-year effect will drop out of annual inflation.
- During the quarter, the US Federal Reserve (Fed) raised interest rates for the first time since 2006, while the European Central Bank (ECB) reduced its main deposit rate further into negative territory, continued to undertake asset purchases of €60 billion per month, and announced that these would be extended into 2017. The Bank of Japan continued with its asset purchase programme, while the People's Bank of China eased policy further in China.
- Trade weighted sterling weakened a little over the quarter, mainly versus the US dollar. On a trade weighted basis, sterling now stands around 11% above its level in quarter one 2013.

BOND MARKET REVIEW

Investment grade financial & corporate bonds

Key points

- Sterling investment grade credit bonds returned 0.37% over quarter four, outperforming UK government bonds by 1.43%, duration adjusted. The positive absolute return reflected a narrowing in credit spreads.
- Average sterling investment grade credit spreads narrowed from 1.49% to 1.38%. Most sectors saw some narrowing in credit spreads, the exception being basic industries, where persistent weakness in commodity prices continued to impact the sector. For the year as whole, average credit spreads widened by 0.12%.
- Bank debt performed well. Subordinated debt, supported by a lack of supply and on-going bond tenders, outperformed senior debt. The insurance sector, having been weaker in earlier quarters, recovered. Overall, financials (banks and insurance) posted the strongest sector returns for the year.
- The more defensive characteristics of asset backed and secured bonds supported outperformance through most of the year. However, these sectors underperformed in quarter four with credit spread compression lagging that seen in the overall credit market.
- The utility sector outperformed, reversing some of the weakness seen in the third quarter. Overall, credit spreads in the utility sector declined by 0.23%, although widened significantly over the year.
- Industrials continued to suffer from the effects of lower commodity prices. Whilst Glencore's bonds stabilised at lower levels, weakness was seen in other commodity related bonds e.g. BHP, Rio Tinto and Anglo American. Over the quarter and year, the sector was markedly wider than any other.
- Despite the sharp drop in sterling bond issuance in the approach to year-end, quarter four issuance was higher than that recorded in quarter three and broadly matched that of quarter four 2014. In contrast to quarter three, issuance was more evenly split between financial and non-financial bonds. At approximately £32 billion for the year, issuance was around 20% lower than in 2014.
- Reversing the trend seen in earlier quarters in 2015, A and BBB rated bonds outperformed higher rated debt. Sterling high yield debt continued to outperform investment grade bonds.
- By maturity, and reflecting the impact of credit spread compression, the highest excess returns were recorded by longer dated bonds, again reversing recent trends.

Outlook

- Liquidity in credit markets remained low, reflecting the on-going capital constraint on banks (fewer resources available for trading fixed income securities). We expect liquidity conditions will remain challenging in the medium term.
- We believe that the current credit spread premium, over UK government bonds yields, adequately compensates for default and other risks (e.g. liquidity and rating migration). We expect that investment grade credit bonds will outperform UK government securities by more than 1.5% p.a. over the next three years.

BOND MARKET REVIEW

Conventional government bonds

Key points

- Conventional UK government bonds returned -1.20% over quarter four as the market sold off due to stronger US data and, as was widely anticipated, the US Federal Reserve (Fed) raising rates for the first time in almost a decade; yields rose across all maturities. For 2015 as a whole, the asset class returned 0.57%.
- On a duration adjusted basis, medium dated gilts underperformed short and long dated gilts; index linked gilts underperformed their conventional equivalents as inflation expectations declined due to further falls in the oil price and an economic slowdown in China.
- The European Central Bank (ECB) cut the deposit rate by 0.1% and extended its quantitative easing programme by six months. Gilts outperformed US treasuries but underperformed European government bonds.
- UK government bond yield curves steepened between 2 and 10 year maturities but flattened between 10 and 50 years, reflecting the market selloff and scepticism that UK base rates will rise, while year-end pressures maintained demand for longer maturities.
- The Bank of England (BoE) Monetary Policy Committee (MPC) left its policy rate and quantitative easing unchanged at 0.5% and £375bn, respectively. Minutes from MPC meetings over the course of the quarter showed a vote of 8-1 in favour of leaving interest rates unchanged, with members highlighting low inflation and geopolitical concerns as a headwind to raising rates too early.
- UK GDP grew by 0.4% in quarter three, resulting in average annual GDP growth of 2.1%.
- UK Consumer Price Index (CPI) inflation rose to 0.1% but the fall in the oil price led many to question whether the 2% target could be achieved on a 2 to 3 year horizon, despite domestic price pressures increasing.
- The Debt Management Office (DMO) announced the issuance schedule for the upcoming quarter, which will be spread across maturities with two short, two medium and three long dated auctions, plus one long dated index linked syndication.

Outlook

- We expect global government bond yields to trend higher from current levels, as economic data continues to improve. As the Fed raises rates further in 2016, we expect the BoE to follow. Our base case assumes a very gradual rise in policy rates, so we do not expect a dramatic sell-off in government bond markets over the next 12 months.
- Our central case is for UK government bond yields across maturities to rise over 2016, and for the yield curve to marginally steepen, although we expect some volatility around this trend.

Index linked bonds

Key points

- Index linked gilts returned -2.89% over the quarter; having reached new lows early in the period, real yields rose across all maturities as the oil price fell further and underlying inflation pressures waned, leading to falling demand for inflation linked securities globally. For the year as a whole, index linked gilts returned -0.97%.
- A 23% collapse in the oil price to 2004 levels led to the re-emergence of deflation concerns, with shorter term breakeven (implied) inflation rates falling.
- 10 year index linked gilt yields rose by 0.26% over the quarter. Despite demand from UK pension funds, 30-year real yields rose by 0.19% over the quarter, and longer dated bonds generally underperformed.
- The current negative level of real yields of -1.10%, -0.60% and -0.64% for 5, 10 and 30 year bonds, respectively, can be contrasted with levels of around 2% when index linked bonds were first issued in the early 1980s, and 4% levels that prevailed in the early 1990s.
- Index linked gilts underperformed their global counterparts. The best performing market was the US, outperforming UK index linked gilt yields by around 0.15% despite the first increase in US interest rates for almost a decade.
- Sterling non-government index linked bond yields underperformed index linked gilts by around 0.10% over the quarter.
- UK Consumer Price Index (CPI) inflation rose to 0.1% but the fall in the oil price led many to question whether the 2% target could be achieved on a 2 to 3 year horizon, despite domestic price pressures increasing.

Outlook

- We believe that a long term real interest rate of -0.64% in the UK, as seen at the end of December, is too low and does 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. Index linked gilt supply is expected to be high over the next three months with a new 2075 issue to be launched in February, which will likely put pressure on longer dated real yields as inflation data improves.
- We continue to believe global inflation linked bonds offer better value than gilts, with real yields of European and US bonds approximately 1.0% and 2.0% higher, respectively, than those of UK bonds.
- We believe that long dated breakeven inflation rates of 3.3% are above fair value. However, 10 year breakeven rates of 2.45% now look undervalued on a longer term basis.
- We believe that 10 and 30 year UK government real yields will rise during 2016.

BOND MARKET REVIEW

Overseas government bonds

Key points

- Having initially tightened, European bonds reversed these moves in December, in what was a very volatile period driven by speculation over the extent of the additional stimulus from the European Central Bank (ECB).
- 10 year US and UK government bond yields rose by 0.23% and 0.20%, respectively, whilst equivalent German and French yields were broadly unchanged over the quarter. Italian bonds outperformed with yields falling by around 0.13%, whilst the corresponding 10 year Japanese yield fell by 0.09%.
- Economic data in the US was mixed. Quarter three GDP fell to 2.0% annualized from 3.9% in quarter two, but strong employment numbers and a small uptick in headline inflation led to the US Federal Reserve (Fed) raising the Federal Fund Rate by 0.25% in December and signalled potential further, gradual rises in 2016.
- Eurozone growth and inflation remained stable, with GDP and core CPI 0.3% and 0.9% respectively.
- Ten year conventional government bond yields in the US, Germany, Japan and the UK were 2.27%, 0.63%, 0.27% and 1.96%, respectively, at the end of the quarter.
- Despite the further decline in the price of oil, global index linked government bonds outperformed, particularly in the US as core CPI picked up rising to 2%. Breakeven (implied) inflation rates in the US rose by around 0.15% whilst in Europe they were broadly unchanged.
- The shapes of yield curves reflected diverging monetary policies. The US curve flattened between 10 and 30 year maturities as the Fed raised rates, whilst the European curve steepened as the ECB extended the region's quantitative easing programme.

Outlook

- We expect that global economic growth will be sustained over the near term.
- We expect US growth to remain reasonably strong and further moves upwards in the Federal Fund Rate in 2016.
- Events in the eurozone will continue to dominate market sentiment. Given the 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, particularly in the UK, 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 believe that developed government bonds markets are expensive, and that yields will rise over the next 18 months.

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 -0.42%; although October showed a solid rebound, posting the strongest monthly return of 2015, it was not sufficient to counteract a weak two months in to the end of the year.
- Global new issuance in the quarter was over USD 50 billion, down 39% on the same period last year.
- The index yield ended the quarter 0.12% higher at 7.34%, with the average high yield credit spread tightening by 0.14% to 5.87% above government bond yields.
- The US and Canada was the weakest performing region returning -2.68%; the UK outperformed, returning 2.14%; Emerging Markets returned 2.00% while the EU returned 1.42%.
- BB rated bonds outperformed B rated bonds, returning 0.51% and -1.64% respectively. Outside of the benchmark index, the Global High Yield CCC & Lower index returned -6.28%. Returns were lower at longer maturities.
- October was a month of recovery on the back of stronger commodity prices, better-than-expected earnings and the People's Bank of China (PBoC) announcing further easing policies.
- In November, the US Federal Reserve (Fed) indicated that it could raise rates in December, while the European Central Bank (ECB) suggested it was ready for further easing policies. Abengoa, a high yield energy issuer of EUR 9 billion debt, was forced to seek creditor protection as insolvency concerns intensified.
- December was focused on central banks; the Fed raised interest rates for the first time since 2006, as was widely anticipated, while the ECB extended its quantitative easing programme, albeit by less than had been expected. Continued weakness in the commodity complex continued to cast a shadow over risk assets.

Outlook

- We expect the performance of the US recovery to underpin the growth in the global economy in the medium term, despite the economic conditions within the eurozone.
- We expect bouts of market volatility due to the tightening of monetary policy by the Fed, as illustrated by the recent interest rate increase. As such we believe bonds with near term catalysts, which mitigate market risk, are an important attribute underlying investment performance over the medium term.
- We continue to believe that Global High Yield bonds are attractive on a spread basis and overcompensate for default risk, while their level of income generation is also appealing.
- The current growth and rate environment provides a moderate default climate, with ongoing refinancing opportunities.

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

INVESTMENT OUTLOOK

Key points

- We anticipate that the current global expansion will be sustained into 2016, with loose monetary policy, low bond yields and a low 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 remain somewhat pessimistic about the prospects for global growth; we expect global bond yields to move higher.

Global economic growth prospects

- We anticipate that the current global expansion will be sustained into 2016, albeit at a lower rate than the pre-crisis average. Loose monetary policy, low bond yields and a low oil price are acting as key supports.
- We expect growth in the US economy to continue, with private sector demand underpinned by rising employment, supportive financial conditions and the impact of a low oil price on households and businesses. These factors should offset the effect of US dollar appreciation and the impact of a low oil price on production from shale deposits.
- For the eurozone, we assume that economic activity is supported by low oil prices, a reduction in fiscal austerity and very low interest rates. Economic news surprised to the upside during 2015, despite concerns surrounding Greece and the Emerging Markets slowdown, and we expect good momentum going into 2016.
- We assume a continuation of trend growth in the UK, with household spending supported by a real income growth and rising employment. The most recent business surveys and other data suggest that momentum in the economy overall has slowed, although it remains positive. Political uncertainty is a significant downside risk, given plans for a "Brexit" referendum. We have not assumed a major setback to growth from Brexit uncertainty, so this is a key downside risk to the outlook.
- In China, we expect GDP growth some way below the official target of 6.5%, as strength is the services economy is offset by weakness in industrial production. The authorities will continue to use policy easing measures to support activity. Continued global growth, cheaper energy costs and loose policy is expected to support modest GDP growth in Japan.

Inflation and growth – how will they impact interest rates?

- We expect UK CPI inflation to remain below the Bank of England's 2% target over the next 12 months, as the effects of sterling appreciation, and falls in commodity prices, feed through. Our base case assumes a gradual firming in wage growth, as the labour market tightens, which should help move CPI back 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 2016. 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

- At current yield levels, we still believe that markets discount quite a bearish view of global growth prospects and 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 during 2016, 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, encouraging 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.

SPECIAL TOPIC

New year, new (and some old) risks

While the Fed rate rise of quarter four may suggest some progress along a possibly long road to 'normality', the path through 2016 may well be just as volatile as that through 2015. A large number of potential sources of volatility present themselves, with strong links amongst many of them. By no means exhaustive, a list of just ten of these is presented below.

China

- A major economic slowdown in China represents the most significant downside risk. The challenge for policy makers remains how to rebalance the economy between investment and consumption, without allowing the overall growth rate to collapse. Concerns surrounding the build-up of "excess capacity", which grew over 2015 as a result of equity market weakness, changes to currency arrangements and weaker manufacturing data, have abated. However, there is still scepticism about the true state of economic conditions. While perhaps unlikely, as a worst-case, the policy makers would be forced to adopt quantitative easing.

Commodities

- Lower commodity prices have been a major factor driving down headline inflation. However, the continued unwinding of the commodity bubble could itself be enough to bring about a financial contagion, beginning in China, spreading through other emerging markets and eventually impacting developed markets.

Emerging markets

- 2015 saw falling commodity prices, rising Fed rates and large currency adjustment across many emerging markets. Continued weakness in emerging markets may create volatility and cause the Fed to hold back on future rate rises. A bad year for emerging markets in 2015 could turn into a systemically bad one for the global economy in 2016.

Oil

- Since oil prices fell below USD50 at the beginning of 2015, there has been speculation of oil prices falling towards USD20, and some movement towards this level. Further such movement would trouble global markets, particularly US high yield and emerging markets. A recovery, over the coming year, back above 50 dollars/barrel is an outcome that would be supportive for risk assets. However, a more aggressive recovery would sharply impact inflation and throw central banks' accommodative policies into question.

"Brexit"

- The timing of a referendum on Britain's membership of the EU, and the likelihood of it even taking place in 2016, depends on how quickly the UK's renegotiation of its terms of membership can be concluded, and how long before French and German general elections in April/May and September/October 2017, respectively. Whatever the timing, implications of an exit on the UK economy are significant, given manufacturing sector weakness versus services, and the UK's reliance on trade with the EU.

European stability

- The threat of eurozone fragmentation may be perceived to have subsided from levels experienced during the heights of the sovereign debt crisis, focused on peripheral countries, most recently Greece. However, the risk remains of increased economic, political and social stresses across the region that could ultimately threaten not only the eurozone but the larger EU.

Reversal or tapering of eurozone QE

- The possibility of either of these occurring in the coming year is remote; it would depend on numerous conditions being met. Should such conditions be met, however, and depending on the growth and inflation outlook at the time, a significant rise in rates could result. This would bring with it the risk of a sharp selloff in credit and equity markets.

US election

- It is unlikely that the Fed will be swayed by the November election, either in advance or as a result. However, a surprise result could bring new policies; while Donald Trump is currently lagging in popularity, should he gain momentum in the primaries, an evaluation of his proposed policies, and how likely it is that they could become law, will be necessary.

US rates and QE

- All of the seven advanced economies that have raised policy rates since the end of the financial crisis have subsequently reversed the move, most notably the ECB, raising rates twice in 2011 before cutting rates effectively to zero. While one would hope that the US will not see itself being added to this group, it is feasible that it may need to reverse course at some point in the next year, especially given how late in this cycle they have been in starting the tightening process. Ultimately, given how low rates might go, this could be the scenario supporting another round of QE by the Fed.

Middle East conflict

- Not to be confused with the separate but significant risk of IS-led terrorist events, in a Middle East already host to numerous disputes and conflicts, a fresh feud between Saudi Arabia and Iran threatens to complicate almost every major issue from the Iranian nuclear deal to the Syrian civil war to global oil markets, with global economic and security consequences.

Source: RLAM. Views expressed are those of RLAM Economist Ian Kernohan.

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.
- 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

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

RLAM TEAM

Your fund managers

Jonathan Platt
Head of Fixed Interest

Paola Binns
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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Product launches

In December we launched the Investment Grade Short Dated Credit Fund. The Fund combines the expertise of Richard Nelson, who manages the Enhanced Cash Plus Fund, and Paola Binns, who manages the Sterling Credit and Short Duration Credit funds. The investment objective of this new Fund is to provide a return from a combination of income and capital growth by investing in a diversified portfolio of investment grade short dated bonds which meet the Fund's predefined ethical criteria. The Fund responds to demand from our institutional clients and offers investors protection from the impact of any potential rise in interest rates.

Corporate team changes

Following the retirement of Tom Meade as Head of Cash in December, Craig Inches was appointed as Head of Cash & Short Rates, combining his existing fund management role with overseeing the RLAM cash suite.
John Dolder was appointed Head of Portfolio Risk following Gareth Hill's appointment as a government bond fund manager and Gavin Creary joined the Portfolio Risk Team as a Portfolio Risk Manager.

Multi Asset team changes

In November 2015 we welcomed Hiroki Hashimoto as a Senior Quantitative Analyst, working on tactical asset allocation and portfolio modelling within RLAM's Multi Asset team, assisting Trevor Greetham, Head of Multi Asset.

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.

Portfolio Valuation

As at 31 December 2015

Dorset County Pension Fund

Holding	Identifier	Asset Description	Market Price (Bid £)	Book Cost Capital (£)	Market Cap. Value (£)	Accrued Inc. Value (£)	Market Value (£)	Days Accrued	Market Value %
Funds Held									
138,089,680	GB00B1ZB3X88	RLPPC Over 5 Year Corp Bond Pen Fd	2.00605	173,183,857.98	277,014,802.89	0.00	277,014,802.89	0	100.0
			Funds Held total	**173,183,857.98**	**277,014,802.89**	**0.00**	**277,014,802.89**		**100.0**
			Grand total	**173,183,857.98**	**277,014,802.89**	**0.00**	**277,014,802.89**		**100.0**

Trading Statement

For period 01 October 2015 to 31 December 2015

Dorset County Pension Fund

	Trade Date	Transaction Type	Nominal	Security	Price (£)	Book Cost (£)
Acquisitions						
Funds Held						
	06 Oct 2015	Acquisition Rebate	103,911.25	RLPPC Over 5 Year Corp Bond Pen Fd	2.02	210,418.21
	09 Oct 2015	Acquisition	136,912.91	RLPPC Over 5 Year Corp Bond Pen Fd	2.02	276,759.86
					Funds Held total	**487,178.07**
					Acquisitions total	**487,178.07**