



# WITH PROFITS FUND

## Investment Report

Second Half 2008 and Outlook



**LIVERPOOL VICTORIA**

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## Investment Report

### Second Half 2008

**This information does not constitute investment advice and we recommend you to speak to a suitably qualified financial adviser before making any investment decision based upon this, or any other, information.**

This report provides information on the performance of the Equities, Property and Fixed Interest investments held in the Liverpool Victoria Friendly Society With-Profits fund, for the period 30th June 2008 to 31st December 2008. These investments are managed by Liverpool Victoria Asset Management Ltd (LVAM). The performance of each of the investment types is measured against an external benchmark, which our fund managers are targeted to beat. Our fund managers have also provided a commentary on each investment type together with their personal outlook.

Every company that offers With Profits investments is required to document the Principles and Practices (the beliefs and behaviours) behind how they manage their With Profits investments; so consumers can understand what to expect from the provider they invest with, or are considering investing with. Our consumer friendly version can be found on the LV= website or a hard copy is available on request.



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## OVERALL COMMENT

Equity markets around the world continued their slide as major economies entered what is expected to be a fairly drawn-out recession although we do not believe we are heading for a depression.

In Tokyo, the Nikkei Index was down 42%\* – its worst annual loss since 1949 when the index was established. The Dow Jones (-34%\*) experienced its worst fall since 1931, while the S&P500 (-38.5%\*) and Nasdaq (40.5%\*) tumbled. The main index in France, the Cac 40 (-43%\*) had its worst annual result in its 20 year history as did the FTSE 100 (31.3%\*), which was set up in 1984. Under these conditions, many investors fled equity markets only to find little comfort elsewhere.

The availability of credit continued to be an issue as the financial system effectively seized up. Government actions around the world to bolster the fragmenting banking system and to boost confidence amongst small businesses and the consumer did not have the desired effect.

Falling house prices, unemployment, or the fear of unemployment and uncertainty about the future has left the consumer weakened although a fall in inflation as oil and commodity prices dropped have gone some way to relieving the strain.

\*Source: Bloomberg

## EQUITIES

	LV=	BENCHMARK
3 months	-8.2%	-7.1%
6 months	-19.7%	-16.9%
12 months	-28.3%	-26.3%

This table complies with the Financial Services Authority's regulations to compare different products from different providers.

These figures measure the growth of our equities portfolio against the Weighted Composite of FTSE Regional Total Return Indices. The figures are as measured at 31st December 2008.

### Standardised Performance

These figures show the percentage growth of the equities portfolio each calendar year in the fund for the last five years.

Yr to 31st Dec 2004	10.9%
Yr to 31st Dec 2005	24.0%
Yr to 31st Dec 2006	14.1%
Yr to 31st Dec 2007	8.6%
Yr to 31st Dec 2008	-28.3%

12 months total return % with gross income reinvested.

Source: LVAM.

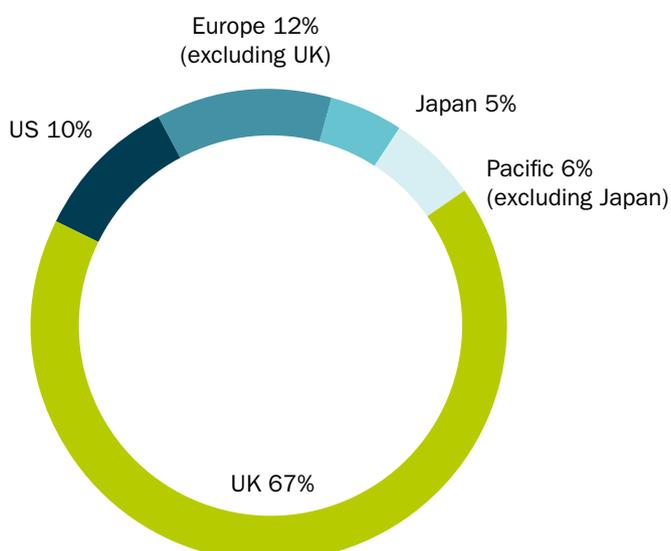
Past performance is not a guide to future performance.

## TOP 10 UK HOLDINGS

as at 31st December 2008

1 Royal Dutch Shell	6 BG Group
2 BP	7 Astra Zeneca
3 Vodafone	8 Tesco
4 HSBC	9 BHP Billiton
5 GSK	10 BAT

Equity Country Weightings as at 31st December 2008



## MARKET REVIEW

It is often said that the month of January is a microcosm of the year ahead and this was certainly the case for 2008. In the **UK**, the FTSE 100 fell by 31.3%\* – its biggest fall since its inception in 1984.

The second half of the year saw repeated government actions to save the ailing financial market. Fears about inflation turned to worries about deflation as food and commodity prices started to plummet and the world appeared to be entering a global recession. Over the year, the price of oil fell from the US\$140 per barrel level to under US\$40.

In an unprecedented move, on the 8th October, the Bank of England (BoE), in conjunction with other central banks around the world, made a coordinated move to cut interest rates by 0.5%. In an attempt to get banks to start lending again and to boost confidence, by the end of the year, the BoE had slashed interest rates from 5.5% to a record-equalling 2% with more cuts on the horizon.

The final three months started with concerns over whether the US bailout plans of US\$700bn would be enough. Various coordinated government actions on interest rates, bailout plans and capital injections went some way to restoring confidence – the availability of credit, however, remained a problem. The lax lending conditions of the past decade came under fire and banks were not willing to expose themselves to any unnecessary risk, resulting in difficulties for small businesses and those seeking mortgages despite record-low interest rates. However, government actions over VAT and sales promotions by high street retailers went some way to relieving the pressures on the consumer.

\*Source: Bloomberg

**European** equity markets were far from immune to the global crisis being referred to as a ‘global heart attack’. After months of displaying its inflation-fighting credentials by not cutting the base rate, the European Central Bank (ECB) took part in the coordinated move, together with other leading central banks, to cut interest rates by 0.5%. By the end of the year, the ECB had cut rates from 4.25% to 2.5%. Falling oil prices helped ease inflationary pressures. With falling inflation expectations and the various economies now in recession, central banks were aggressive in their monetary policy easing.

Drastic times deserved drastic measures and after some confusing starts in the US (hampered by a lame duck president and elections,) the policy response in terms of rate cuts and the Troubled Assets Relief Programme (TARP) (nationalisation of banks, AIG, buying up of toxic assets) was unprecedented. This was followed by promises of massive fiscal stimuli (ranging from the different advanced economies of

between 0.7% and 1.5% of GDP) which helped to stabilize fragile credit and interbank markets and more importantly towards the end of the year brought down borrowing rates for consumers. However, the continuing fallout from the global credit crisis played out until the end of the year. Economies around the globe slowed dramatically as demand for goods slowed, the cost of doing business increased and consumers became concerned about their future.

The financial and economic situation in the **United States** continued to deteriorate as the last six months of the year saw the collapse and takeover of a number of large banks summoning the demise on Wall Street of the pure investment bank model. With the interbank money market effectively dead, the Treasury announced its intention of implementing the Troubled Assets Relief Program (TARP). The main objective of this US\$700bn plan is to buy the more distressed assets held by the banks that still hold some intrinsic value achieving two objectives in the process: removing “toxic” assets from the system to restore confidence between banks, and help banks recapitalise. Inflation eased back due to deterioration in private consumption and helped by a fall in the price of oil and other commodities. The job market continued to worsen with weekly jobless claims rising to their highest level since September 2001 partly inflated by the impact of hurricanes.

Over the year, US equities declined amid slowing consumer demand, rising unemployment, and frozen credit markets. Stocks experienced their worst annual decline since 1937. The economy, which first turned down in December of 2007, was officially declared to be in recession. Other events that helped soothe investors’ nerves included the Federal Reserve’s move to slash the fed funds rate to all-time lows, news of a proposed stimulus package from US President-elect Obama’s administration, and anticipated government aid to US automakers.

The **Japanese** equity market continued to fall during the second half of the year, intensifying towards the end of September as the global credit turmoil escalated although the weakening of sterling against the yen worked in favour of British-based investors.

Despite concerted official action to stabilise the financial system, the risk tolerance of investors collapsed and the market briefly plunged to a new post-bubble low in October. The credibility of many financial products and institutions fell to new lows, and participants in the Japan market joined a global rush to liquidity.

In response to the deteriorating economic environment, the Bank of Japan cut its policy rate twice, in October from 0.5% to 0.3%, and then in December from 0.3% to 0.1%. The central bank also announced plans to increase outright purchases of government bonds and to start buying commercial paper – a return to

quantitative easing. However, these policies seemed to follow the Federal Reserve's policy and were unsuccessful in providing a positive surprise to the Japanese equity market.

Manufacturing industries that are most sensitive to foreign demand, including vehicle makers and electronics companies, nosedived. Many companies announced substantial earnings downgrades during the first half earnings reporting season as fading global demand and the substantial strengthening of the Japanese yen against most other currencies took hold.

In **Asia**, the fear of inflation rapidly receded to be replaced by clear evidence of a global economic slowdown. With falling demand from developed economies, the export-driven economies of the Pacific Basin suffered, while plummeting commodity prices and declining exports hurt Australian equities.

Observers of the Chinese economy, the engine of Asia, were confused by the impact of the Olympics, which clearly caused a temporary halt to activity in many sectors. However, it became clear in September that a broader slowdown was occurring, particularly for net exports and residential construction. Equity markets throughout the region suffered, although a strong bounce was experienced in December. Economic and corporate data globally was poor in the fourth quarter, with earnings downgrades, equity raising, rescue plans as well as weak employment, retail and manufacturing data. Encouragingly, global governments have been very aggressive and united in their response with large fiscal and monetary stimulus expected to continue into 2009. In Asia, China was the best performing market with massive Chinese fiscal spending and aggressive rate cuts giving comfort.

## PERFORMANCE

In the second half of the year, **UK** results were hurt most of all by stock selection among the Financials sector, particularly the Banks and Non-life Insurance sectors.

The increased volatility in equity markets saw a massive flight to safety and risky assets were shunned at every turn. This saw utility stocks with their low growth but non-cyclical revenues and cash flows outperform. We were underweight in this basket. This comment would equally apply to pharmaceutical stocks which also performed strongly given the move in the sterling-dollar exchange rate. Whilst our underweight position in Utilities and Pharmaceuticals hurt relative returns, in part this negative was offset by positive returns from our holdings in other defensive areas of the market such as Tobacco, Telecommunications and Food Retail.

Our holdings in Industrials also hurt relative returns. Towards the end of the year a move to increase

interest-rate-sensitive stocks proved premature (Persimmon in the House Builders and Cookson and Charter in the Industrials).

There was a negative impact from too much exposure to the Mining sector and specifically in the Diversified Mining company Xstrata. Commodity prices were squeezed lower by fears of a collapse in the demand environment and by technical selling pressure from hedge funds and investment banks forced to sell out of positions due to the credit crunch.

Good stock selection in Construction and Support Services (Balfour Beatty, Babcock, Serco) helped as share prices began to reflect possible extra government spending and outsourcing. There was a positive contribution from stock selection and an overweight stance in the Aerospace and Defence sector, which provides good long-term visibility due to income generated from contracts running into the future on many civil and military platforms.

The **Europe ex-UK** part of the fund is focussed on companies operating in areas where supply is scarce and demand strong leading to sustainable pricing power. The result of this is an overweight position in the Infrastructure sector, such as Power (Siemens, ABB), Motorway and Utilities (E.On).

The same philosophy made us sceptical of companies with earnings based on discretionary consumer spending (Autos), and Banking. In addition, we have not chased perceived value in more traditionally defensive areas such as Telecoms and Healthcare, as we do not see pricing power in these areas.

Despite the tough economic and market conditions, the portfolio ended the year with more positive news to report than negative news.

A large underweight position and our choice of stocks among Financials were the greatest positive contributors to the outperformance in the final quarter. Key was to avoid the "blow-ups" such as ING and to avoid stocks with exposure to Emerging Europe (especially countries such as Ukraine and Russia). Despite poor returns from the fund's overweight holdings in the National Bank of Greece, Credit Suisse, AXA, Société Général and Allianz, positive returns from an overweight position in Zurich Financial and a lack of exposure to ING and Deutsche Bank and Unicredito contributed to the fund's outperformance in this sector.

The fund's Energy holdings and greater-than-benchmark weighting in this sector also benefited relative returns, with a large relative position in Total the main contributor.

The fund's Industrials holdings and an overweight position in Telecoms (Telefónica, Swisscom) were also beneficial but relative performance was dragged down by stock selection among Utilities.

Poor performance continued into the third quarter as the **US** portfolio underperformed the benchmark, primarily due to stock selection while asset allocation was the main culprit in the last quarter of 2008. An overweight position in Financials was detrimental to returns as shares in Merrill Lynch and Bank of America tumbled. The fund has now sold out its position in Merrill. However, overall, our choice of stock in this sector was beneficial to relative returns. Reducing our holdings in Citigroup and closing our position in Huntington Banc benefited relative returns.

Selection of stock among the Materials sector was another drag as shares in Alcoa, one of the world's largest producers of alumina, fell, with the global downturn continuing to affect demand.

The greatest detractor from relative returns came from our overweight position and selection of Information Technology companies. A large overweight position in video game creator Electronic Arts was the main laggard as its share price continued to fall.

The fund's greatest positive contribution came from our Industrials holdings as shares in Delta Air Lines rose. Delta Air Lines is not represented in the benchmark index.

As sterling fell against the dollar, the fund also benefited from its cash holdings, which, of course, the index was unable to do.

Stock selection among Energy (Exxon Mobil) pulled down relative returns, as did our underweight positions in Consumer Staples and Telecommunications. Finally, the benefit derived from our choice of Health Care companies (Wyeth, UnitedHealth, Schering-Plough) was more-or-less nullified by the underweight position in Utilities.

Entering the second half of the year, sector allocation for the **Japan** portfolio had a negative impact on relative performance, although the contributions from each sector were mixed. The market's preference for domestic and less economic-sensitive sectors continues, and the underweight position among Infrastructure companies had a negative impact. Utility stocks did well despite their vulnerable fundamentals and overvaluation. The underexposure to the Medical sector detracted from relative performance although our main holding, Shionogi, has continued to outperform, following favourable earnings results from sales of its main anti-cholesterol drug Crestor.

The overweight position in the Communication sector contributed positively. Earnings of the wireless telecom carriers are expected to benefit from the growth in mobile phone sales using instalment purchase plans.

The underweight exposure to the Financials sector added value. However, choice of companies in this sector detracted from relative performance. Orix

fell heavily as market participants seemed overly concerned about its liquidity and credit risk.

The yen's rapid strengthening and a slowdown in sales had a negative effect on the share price of export-oriented automobile, machinery and electronic manufacturers. Our selection here had a negative effect on results.

Positive relative performance continued into the second part of the year for the **Asia-Pacific** part of the fund, mainly due to stock selection. Indian stock selection benefited from a somewhat defensive stance focused on quality growth companies (Bharti Telecom, HDFC Bank). In general, where we were somewhat defensive (e.g. Telecom companies) and avoided Commodity companies (e.g. Oil), the fund outperformed (Australia, Taiwan, China, Indonesia). Where we owned more Commodity or had greater exposure to volatility (e.g. Property), the fund underperformed (Hong Kong, Singapore, Thailand). Asset allocation benefited from holding higher than normal cash levels, a deliberate policy to lower the volatility of the portfolio.

During the closing months of 2008, the relative positive performance continued. The overweight positions in long-term favourites, China and Hong-Kong, proved beneficial although other perennial top-slotter Australia, India and Korea produced negative returns. However, stock selection in Australia and India meant that holdings in these countries outperformed in relative terms. A number of futures contracts worked against the fund's favour. Amid the global economic slowdown, shares in Industrial and Materials companies were down and our holdings in energy resources engineering company WorleyParsons and miner Rio Tinto as well car manufacturer Hyundai were detrimental to returns. Positive contributions came from a number of holdings including Queensland Gas and telecoms companies, Hutchison Telecommunications and China Mobile.

## OUTLOOK

The **UK** is facing tough economic conditions. The reduction of debt by the banking system, the corporate sector and for individuals is combining to produce recessionary conditions in 2009 when GDP numbers are expected to be the weakest since 1991.

The UK consumer is the most indebted of the G8 consumers, UK housing still some of the most overvalued and the fiscal position already relatively stretched given how strong economic activity has been for the previous 10 years.

The problems in the banking system are now beginning to be evidenced in the real economy. Credit availability to both the corporate and personal sectors has declined sharply and mortgage approvals are running

at all-time lows. Measures of corporate liquidity suggest a nasty contraction. These all point towards a deep and lengthy recession.

The effect of falling UK house prices on consumption has been estimated to be the greatest of any of the developed markets. With house prices already down about 15% and around another 15% fall forecast, this will put further pressure on consumption. The collapse in consumer confidence is therefore no surprise.

The upside is that policy action, while initially slow, moved into overdrive during the final quarter of 2008. As a result of government and central bank action, it is forecast that the recession will be technically contained to 2009.

The recovery in 2010 is forecast to be tepid. GDP growth of less than 1% will feel like a continuation of the tough conditions in 2009. It is not until 2011 or maybe 2012 that recovery will be more robust.

However, even then we expect that the ongoing rebalancing of the economy with reduced consumption and the rebuilding of personal and corporate balance sheets will lead lower-than-expected growth. The outlook for the UK economy is therefore challenging for an extended period.

While the outlook remains uncertain, the portfolio is constructed to benefit from investments in companies with secure income streams who will be able to grow cash profits despite the uncertainties in the economy. In addition, we have sought to remove investments that have financing risk.

Tight credit conditions, weakening consumer demand and rising unemployment will leave **Europe** facing very tough headwinds in 2009 – a recession would put a lot of strain on markets where consumers and institutions are heavily in debt. As world regions head into recession and the emerging markets experience a significant slowdown, Europe will inevitably be caught up in the turmoil. Arguably large parts of Europe (Germany, France) participated to a much lesser extent in building up debt and should be able to weather the storm better. The other side to this coin is exemplified by the likes of Spain and Ireland where news flow will remain poor as debt is repaid.

Tighter credit conditions will lead to an increasingly restricted borrowing environment for both the consumer and corporate sectors. However, savings ratios in parts of Europe, notably Germany, are healthier than in the UK and US.

We continue our search for quality stocks that have been oversold in this environment in combination with some of the more traditional defensives such as telephone companies. The overriding theme is healthy cashflow and balance sheets. A key theme is

underweighting stocks and sectors that are exposed to Capital formation and discretionary expenditure. With companies facing slowing demand and capacity utilisation rates falling a sensible way for a company to defend margin is by restricting capital expenditure to a care and maintenance level.

For example, we are overweight in Upstream Oil companies, where cash flows are stable but underweight in the Oil Service sector (eg Saipem) which is dependent on Exploration and Production not cutting their expenditures.

After such large stockmarket falls, there are always excellent investment opportunities and the market is always quick to discount bad news. We are happy to invest in companies which have sound balance sheets (preferably net cash) and where they have an element of self-help. In other words we all know demand is going to be weak but where there is good control over supply through coordinated industry production cuts (i.e. Potash), or a delay in new capacity coming on stream (Nitrates, Oil) and hence pricing power and margins can be defended.

The **US** economy is declining at its sharpest pace in recent history. The fourth quarter is on track to show a sequential real GDP decline exceeding 6% at an annual rate. While the current pace of decline is unlikely to persist for long, further significant contraction is still expected in 2009. With a little luck, the economy could reach its trough sometime over the summer. Depending on which sector you look at, the recovery trajectory differs. The pace of the decline in housing should moderate in early 2009. Consumption should have the worst declines by Spring, while the capital goods sector is poised for an accelerated pace of decline until the end of the year.

After emerging from perhaps the worst decline in postwar history, this rebound is likely to pale in comparison to previous recoveries. This is because the process of paying off debt will continue to be felt for years to come. The balance sheet destruction that has resulted from the combination of falling stock prices and declining real estate values is stunning. So far, consumers have lost US\$9 trillion in wealth, over double the drop we experienced when the bubble in equity markets burst earlier this decade. Yet debt levels remain sky high. Looking forward a few years, we should expect consumers to save more, to invest these savings more conservatively, and to acquire less debt in the process. In addition, the painful memories of the current environment will be with the financial sector for a long while, suggesting a more prudent approach to lending in the future. Faced with the amount of debt that needs to be paid back, private economic growth is likely to expand by a meagre 2% post-recession, leaving it up to the government to fill a

void and to become a more important source of growth in the economy.

In **Japan**, the earnings downturn is likely to extend into 2009, with the Japanese economy possibly facing a prolonged recession. After revising our growth forecast, we expect Japan's real GDP to contract by 1.2% in fiscal year 2008 (ending March 2009), and to fall a further 1.6% in fiscal year 2009.

Weak overseas demand, tighter credit conditions, and delays in domestic fiscal policy implementation indicate that the first quarter of 2009 could be a difficult and volatile period for the Japanese economy and stock markets.

There are anecdotal signs that the market could be attempting to bottom out, given that recent reports of losses and downgrades have failed to precipitate further drops in share prices. Other valuation measures, such as dividend yields also suggest some attractive opportunities in the Japanese market.

Given the stability and better earnings visibility of the Communications sector, the fund shall maintain its overweight exposure here while reducing the overweight position in Commodities. Basic materials producers face severe downward price pressure from manufacturers. While the fund still maintains an underweight position in Financials, most of the bad news now appears to be priced in after the steep fourth quarter market downturn. Accordingly, we are proposing to raise the fund's financial sector position.

### Asia-Pacific

The unfolding global crisis will likely be a multiyear event. The pace of economic decline in the fourth quarter of 2008 and early 2009 is expected to be the worst in decades. Equity markets should bottom out over the summer, as the coordinated global policy response kicks in. We expect an economic upturn in 2010, but believe that this upswing will be below par compared to previous recoveries as the global financial system needs more time to heal. In terms of regions, we expect emerging Asia's expansion to have the most staying power in the coming years.

## PROPERTY

	LV=	BENCHMARK
3 months	-12.5%	-13.8%
6 months	-16.2%	-18.1%
12 months	-21.8%	-23.1%

This table complies with the Financial Services Authority's regulations to compare different products from different providers.

These figures measure the growth of the property portfolio against the IPD UK Annual Index. The figures are as measured gross at 31st December 2008.

### Standardised Performance

These figures show the percentage growth of the property portfolio each calendar year in the fund for the last five years.

Yr to 31st Dec 2004	19.7%
Yr to 31st Dec 2005	20.5%
Yr to 31st Dec 2006	22.2%
Yr to 31st Dec 2007	-1.2%
Yr to 31st Dec 2008	-21.8%

12 months total return % with gross income reinvested.

Source: LVAM.

Past performance is not a guide to future performance.

## MARKET REVIEW

Property prices continued their decline from the end of 2007 throughout 2008, with values down by 30% in the 18 months since their peak in July 2007. The decline equals the peak to trough of the early 1990's which took three years in total.

The previous years of outperformance by the property sector had been fuelled by the availability of cheap finance (estimated at over £200bn by mid 2008). There was a marked deterioration in market conditions towards the end of the year in reaction to the negative news coming from the banking sector. Values fell by 15% in Q4 2008.

Unemployment, consumer retrenchment, weak house prices and falling business confidence are now impacting on rental growth which after five years of positive movement has turned negative to stand at -1.44% for the year ending December 2008.

Average returns over the last three years have been significantly affected by the fall in values but property has managed to maintain a position between the two main asset classes.

## PERFORMANCE

The fund continued its trend of out performance although returns for the year were negative at -21.8% against the benchmark return of -23.2%.

Performance was driven by a full reappraisal of the funds residential block at Dukes Lodge, Holland Park and the sale from the Great Victoria Partnership of the former Liberty block on Regent Street London W1.

Also, rent reviews and lease renewals across the portfolio have been maintained at rents at or above estimated rental values, whilst lettings have been achieved keeping void rates at 6.7% against the IPD Benchmark of 10.4%.

The composition of the fund, with an over weight position in the industrial sector whilst under weight in offices, has also driven the out performance.

## OUTLOOK

Market conditions are the worst they have been for over 30 years with the market bereft of finance, both equity and debt. The traditional buyers of UK real estate – the UK Institutions – face either asset allocation issues or redemptions from unit holders. Many funds, however, have been closed to further redemptions for up to six months whilst others are imposing a liquidity premium. Sales at this stage of the market are not recommended as only the funds' core assets and their very best income would attract interest, with the resulting portfolio skewed towards short-term income and thus higher risk assets. Conversely, we should be open to seeking new opportunities for investment as the fall in market sentiment is now presenting exceptional buying opportunities and whilst we are not there yet, when the market does return, we expect that it will do so very quickly.

## FIXED INTEREST

	LV=	BENCHMARK
3 months	8.5%	9.5%
6 months	11.7%	13.0%
12 months	7.2%	8.7%

This table complies with the Financial Services Authority's regulations to compare different products from different providers.

These figures measure the growth of our Fixed Interest portfolio against the Composite of 75% FTSE A Over 5 years UK Gilts Total Return Index and 25% Merrill Lynch over 5 years UK Non-Gilts Total Return Index.

The figures are as measured at 31st December 2008

### Standardised Performance

These figures show the percentage growth of the fixed interest portfolio each calendar year in the fund for the last five years

Yr to 31st Dec 2004	7.7%
Yr to 31st Dec 2005	9.7%
Yr to 31st Dec 2006	0.3%
Yr to 31st Dec 2007	3.7%
Yr to 31st Dec 2008	7.2%

12 months total return % with gross income reinvested.

Source: LVAM.

Past performance is not a guide to future performance.

## MARKET REVIEW

From July, the price of oil started to fall from its US\$140 per barrel peak bottoming at under US\$40 by the end of the year.

The UK government started to slash rates more aggressively than the market had anticipated, from a year high of 5.5% down to a record-equalling low of 2% at the end of December. The most aggressive cut came on November 6th when the Monetary Policy Committee (MPC) cut rates by 1.5%, a full 1% more than the market had expected. Amongst the reasons for such a cut, the MPC cited the substantial drop in oil prices and the noticeable impact it would have on headline inflation.

In the final three months of the year, the UK government bond market rallied in the 10-year part of the curve. For the same period, 30-year yields also rallied. However, due to their much higher duration, 30-year bonds outperformed 10-year bonds by as much as 5.5% in absolute terms over the quarter.

The inflation linked bond market underperformed the conventional market as deflation fears sieved into the market and the risks of recession increased. At one point, expectations for the market Retail Price Index – a measurement for inflation – for the next five years fell as low as -1.14%.

## PERFORMANCE

The portfolio's positive performance continued although results were behind the benchmark index return in the third quarter. On the yield curve, very long dated bonds underperformed shorter dated bonds as the yield curve steepened dramatically.

The market became convinced that the economic outlook was deteriorating faster than had been previously expected. This resulted in shorter dated bonds pricing in expectations of substantial cuts.

The team anticipated the relative outperformance of the long end and positioned the funds accordingly, contributing positively to performance.

In an effort to restore confidence and increase interbank lending, in October, the government announced a credit guarantee scheme to guarantee a wide range of bank borrowing. The guarantee certificates cover deposits, commercial paper, senior unsecured bonds and notes as well as other banking instruments. Government guaranteed bank paper is very attractive for the security it offers, in addition to the greater yields it presents over Gilts and it was for these reasons that the team decided to participate in this scheme through purchasing paper for the fund.

## OUTLOOK

We believe the continued cheapening of credit offers great opportunities in the medium to long term and are positioned accordingly. The implementation of explicit government guarantees on bank paper has seen an increased supply of short-dated banking credit with good attractive spreads over government bonds. We have participated in a number of these new issues and will continue to do so in line with current investment views and restrictions.



