INVESTMENT NEWS

MONTHLY NEWS BULLETIN FROM THE INVESTMENT AND RISK TEAM

GAD

2 April 2013

01

MONTHLY UPDATE

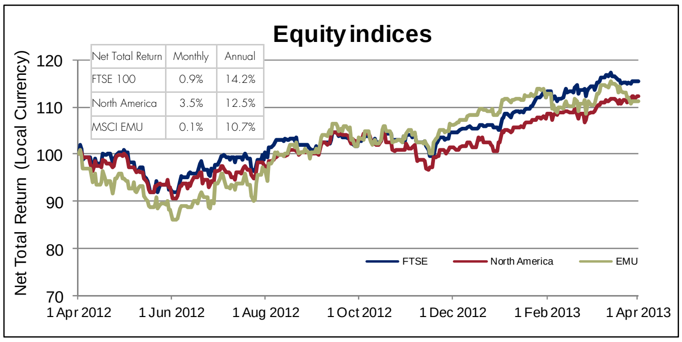
Overview

George Osborne unveiled his fourth budget as chancellor this month. It included lowering corporation tax to 20%, increasing the personal tax allowance to £10,000 a year earlier than planned (in 2014), and offering shared equity loans to home buyers. The Bank of England's 2% CPI inflation target was reaffirmed; however, an updated remit made clear that the Bank would be able to provide more explicit forward guidance, such as the US Federal Reserve has done in making a commitment to keep interest rates low.

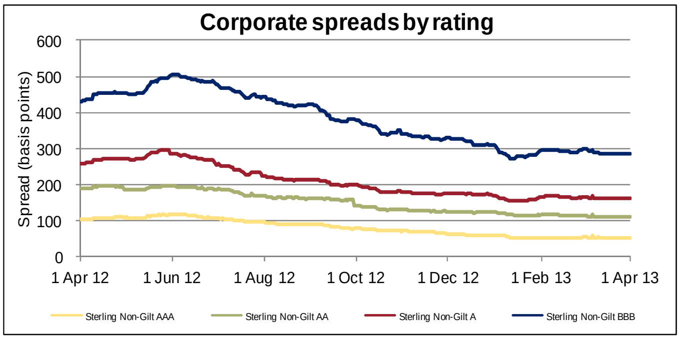
The Office for Budget Responsibility (OBR) revised its growth forecast for 2013 downwards from 1.2% to 0.6%. The OBR does not expect the economy to contract in the first quarter, therefore avoiding a triple-dip recession. Quarterly unemployment figures were also announced this month showing a rise of 7,000 to 2.52 million. Despite this, unemployment is lower now (7.8%) than it was a year ago (8.3%).

Following a week of uncertainty, eurozone leaders have agreed a €10bn bailout for Cyprus with the EU and IMF. The deal represents the first of the five bailouts in the currency bloc where depositors have shared the cost, although savings of less than €100,000 will not be affected. The losses to those above that threshold may be as high as 40%, spreading investor concerns that a similar model could be used elsewhere for any future bailouts.

Equity markets showed modest growth over the month



Credit spreads were broadly unchanged

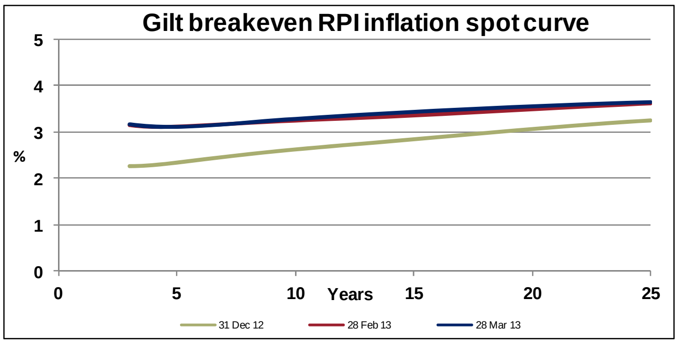


LATEST ECONOMIC NUMBERS

Current base rate	0.5%
Quantitative easing level	£375bn
CPI increase Feb (%y/y)	2.8%
Halifax house prices Feb (%m/m)	0.5%
IPD TR property index Feb (%m/m)	0.3%
PPF 7800 funding ratio	84.6%
VIX (volatility) index	12.7
$/£ exchange rate	1.52

Numbers as at the end of month unless stated

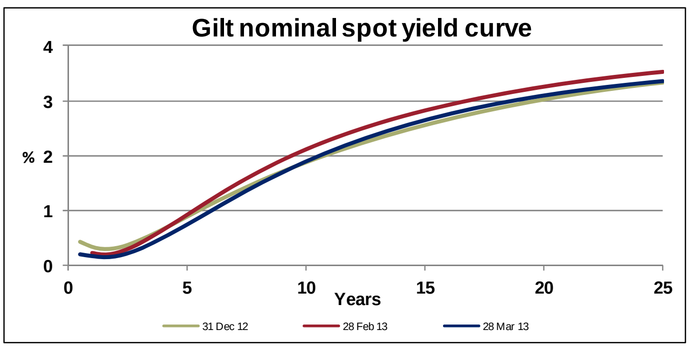
Breakeven inflation rates were broadly unchanged this month



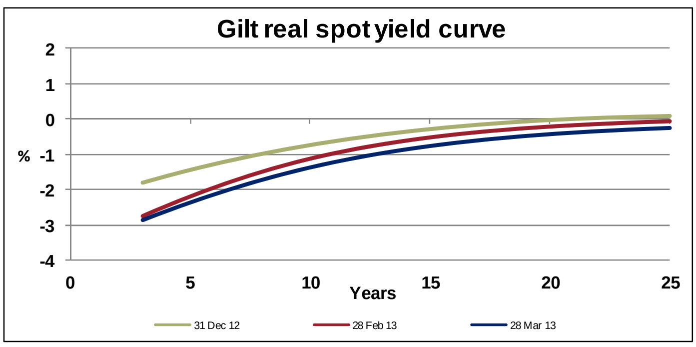
CALENDAR OF EVENTS AND DATA RELEASES

MPC interest rate announcement	4th April
UK Trade	9th April
Producer Price Index	16th April
RPI / CPI	16th April
Minutes of MPC meeting	17th April
UK GDP Q1 Preliminary estimate	25th April

Nominal yields fell slightly this month



Real yields fell this month



All chart data sourced to Bank of England, Merrill Lynch, Financial Times, MSCI & Standard and Poor.

INVESTMENT NEWS

02

MONTHLY NEWS BULLETIN
FROM THE INVESTMENT AND RISK TEAM

2 April 2013

An introduction to hedge funds

Hedge funds have significantly increased in popularity over the last 20 years, with an estimated 10,000+ funds operating globally which manage over $1tr of assets (source: OECD) - see Box 1. This month we look at what hedge funds are, how they might operate, and their characteristics which may be of interest to different investors.

Introduction

The term 'hedge fund' was originally used to describe investments which took offsetting positions to hedge market risk, though it is used so much more widely today that it is difficult to give a precise definition. They are generally pooled investment funds set up as private partnerships, which are open to a limited number of investors and might require a significant level of minimum investment. They are (usually highly) actively managed with few investment restrictions or regulatory requirements, and with the aim of achieving high absolute returns. In that sense the modern use of the term 'hedge fund' is perhaps misleading, since 'hedging' is usually the process of reducing risk while some hedge funds are very much at the high risk/return end of the investment spectrum.

Hedge funds are generally open ended, allowing investors to add or remove their investment in the fund. They are typically valued using a net asset value approach, though intangible assets such as 'reputation' and key employees/managers may also be significant elements.

Trading strategies

Hedge funds can invest in a wide range of assets using a number of different strategies, including:

> 'relative value' - by attempting to calculate the 'fair' value of other securities, any temporary mispricing in the market can be exploited;

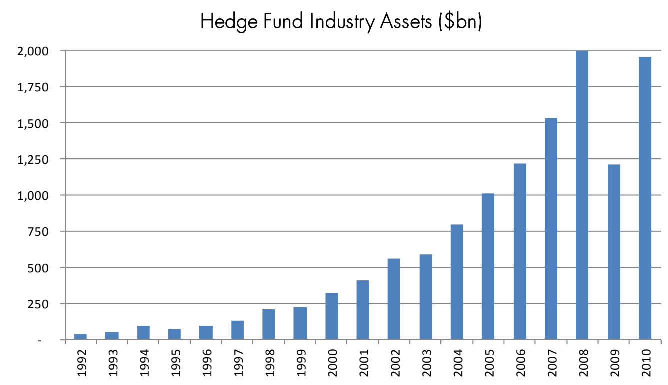
> 'event driven' - targeting investment opportunities based around corporate events, such as mergers or insolvencies;

> 'directional' - anticipating trends and movements in the direction of markets perhaps by taking long/short positions;

> 'fund of funds' - a hedge fund based on a number of different underlying hedge funds.

The risk/return profile of a particular fund is determined largely by the strategy which is adopted. For example, strategies which bet on larger future movements (perhaps due to anticipated macroeconomic shifts) might carry more risk.

Box 1: Growth of hedge funds: 1992-2010



Data source: Hennessee Group LLC

Hedge funds can also use leveraging to increase their exposure to investments, which in turn can increase the level of risk being taken.

Investment characteristics and suitability for different investors

Some hedge fund investments have produced a high level of returns uncorrelated to those in other asset classes. However, there have also been some high profile collapses. The performance of a given fund rests critically on the skill and insight of the investment manager. Further, a hedge fund may only disclose information on its performance and general strategy to it's clients. Assessing the suitability of a given manager's experience can therefore be difficult. Such expertise can command high fees so that any improvement in performance may largely be lost – the resulting position of moderately higher (net) returns but considerably higher risk may not be so attractive. Performance related fees can help ensure the fund managers' interests remains aligned with those of the investors.

The relative lack of regulation, and the typically large minimum investment requirements, mean that hedge funds are better suited to large, financially aware investors. They may therefore be attractive to very wealthy individuals, or professional investors such as insurers or pension funds. The popularity of hedge funds to the latter is growing—it is estimated that up to 20% of European and US pension funds invest in them (source: OECD).

While offering the potential of diversification and improved asset returns, there are considerable risks to pension schemes investing in hedge funds. Some trustees might not have the appropriate level of financial understanding to appreciate the risks that are involved. Leveraging and the use of novel investment assets may result in greater investment risk. The relative lack of regulation reduces the level of reporting and disclosure, which, increases operational risk, makes it difficult to understand the risks of a particular fund and makes assessment of the likely future returns more challenging.

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